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Regulation

Jan/Feb 1984

AEI Journal on Government and Society

INDEX Volume VII

'Round and 'Round on RPM

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EDB and the Marigold Option

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THE ELUSIVE CARROT: TAX INCENTIVES FOR R&D

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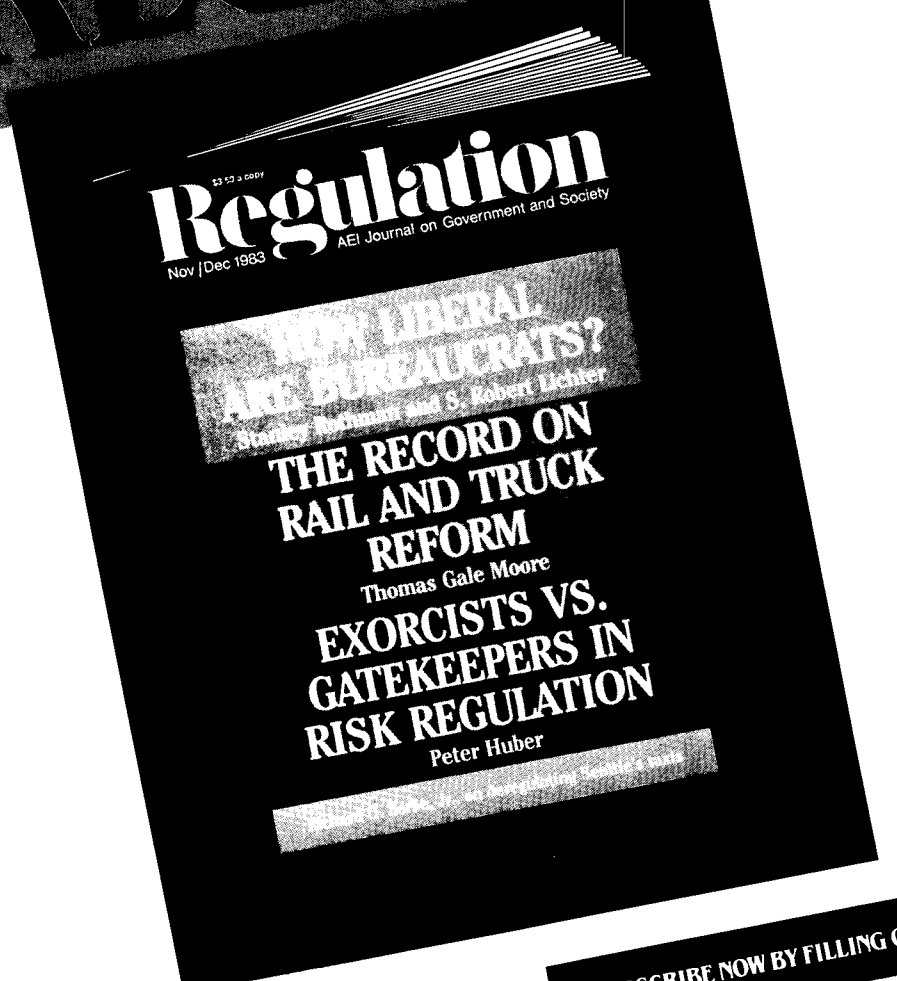

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

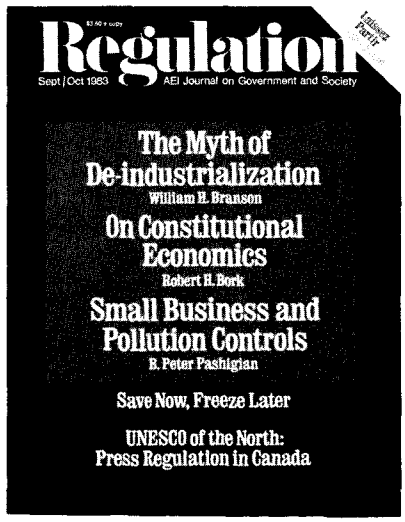
Small Business and Pollution Controls

TO THE EDITOR:

B. Peter Pashigian's article ("How Large and Small Plants Fare under Environmental Regulation," *Regulation*, September/October 1983) asks a very important question: Do environmental laws and regulations unintentionally impose more of a burden on small business than on large and, if so, what effects have resulted? I will not take issue with Pashigian's findings here, since the evidence he presents is skimpy (although amplified in another journal), and since the cause-and-effect relationship he deduces is based solely on statistical inference, which traditionally suffers from potentially serious defects.

Instead I want to challenge this statement from his concluding paragraph: "The disproportionate burden placed on small plants in the high abatement-cost industries may be a recognized and accepted consequence of that program or it may be an unintended effect. If these effects were unintended, it is surprising that no serious effort has been made to modify them. Congress and the Environmental Protection Agency usually respond promptly to the vocal complaints of small business. But special treatment for small plants would produce determined opposition from owners of large plants (as well as from environmental groups)."

It is a very large jump from the notion that there is an unnecessary burden on small business to the notion that EPA intends that burden or has done nothing to rectify it. As an adviser to EPA on small business issues and to the Vice President's Task Force on Regulatory Relief, I have watched EPA take an intense interest in reducing whatever unnecessary burden its actions place upon small business. In my view, it is fully aware that environmental and other regulations significantly affect small businesses' economic performance. Among the specific problems the agency is actively studying are the following: that small businesses have higher unit compliance costs than larger businesses, and less access to policy makers; that they have trouble getting outside financing for pollution-control investments; that the agency lacks adequate information on



the impact of its policies on small business; and that policy makers neglect the cumulative effects of agency regulations and, in fact, do not adequately understand their own regulations as well as they should.

EPA has a Small Business Ombudsman who helps small businessmen gain access to the agency and comply with its requirements, and who works on policies and regulations to provide maximum flexibility. Where a statute is responsible, the agency looks for legislative measures it can recommend for relief. Reforms are beginning to emerge in specific program areas such as effluent guidelines, many of which exempt small plants. This is all *over and above* the various government-wide measures that address small business concerns, such as Executive Order 12291, the Regulatory Flexibility Act, and the Paperwork Reduction Act.

The most pressing need for small businesses at present is for information about regulatory requirements. EPA offers assistance in this area, but small businesses do not know much about it or make much use of it. They view it as expensive and time-consuming and apparently fear that EPA will "recognize" them as polluters if they step forward for help. EPA will hold a Small Business Conference this spring in an effort to learn more about their needs.

If there is indeed any "unintended small business bias," EPA is doing its best to remedy the problem. It is in the legislative arena that many of Pashigian's concerns—if they are legitimate—must be resolved.

Wilbur A. Steger,
CONSAD Research Corporation

TO THE EDITOR:

Pashigian's analysis would be far more convincing if his data accurately described the costs of the Clean Air and Water Acts as he claims. Unfortunately, Pashigian (along with others) has been misled as to what the Department of Commerce's estimates of pollution abatement costs and expenditures really mean.

Those estimates are of total *expenditures* for pollution control, regardless of why the expenditures were made. What many forget is that pollution control was not invented by the government in 1970. By then, many industries had already had long histories of pollution abatement expenditures, as a result of local ordinances, concern for worker safety, need for materials recovery, and simply good citizenship. Thus the estimates hardly describe the *incremental* costs of complying with EPA regulations.

Indeed, Resources for the Future (RFF) data based on engineering analyses of the regulations indicate that the incremental costs of EPA regulations to certain firms in highly polluting industries are often zero. The reason is that when the

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agency drafts the permit guidelines it often defines the "best technology"—which is what the regulations call for—to mean what the big firms are doing anyway.

Because of that interpretation and because new sources often face more stringent standards than older sources, the regulations probably do help strengthen big firms relative to smaller ones, as Pashigian claims. However, the real sufferers from the policy may be the medium-sized firms, not the very small ones. Small-firm exemptions from the regulations are quite common, and even when small firms are not exempted they are frequently given weaker standards. However, the quantitative effects are still to be determined. I suspect from examining our own RFF data on incremental costs, which are much lower than indicated by the Commerce data, that the effect of these costs on the size distribution of firms is much smaller than Pashigian believes.

Henry M. Peskin,
Senior Fellow,
Resources for the Future

PETER PASHIGIAN responds:

Wilbur Steger tells us that the Environmental Protection Agency has seen the light. It is now, if somewhat belatedly, addressing those problems of small businesses that are caused by compliance with environmental regulations. According to Steger, EPA now has a Small Business Ombudsman to help small business. It also tries to provide maximum flexibility and to reduce unnecessary burdens placed on small business. What should we make of this list and these assurances?

Steger asks us to judge EPA by the efforts it has made to rectify the situation, not by the results of those efforts. His argument would be far more convincing if he showed that the agency's new concern had reversed the decline in the market share of small plants. Unless and until a convincing demonstration is offered that it has, many of us will remain skeptical.

And rightly so. The Environmental Protection Agency is, after all, an administrative agency constantly buffeted by the demands of competing interest groups. Its freedom of maneuver has been and is circumscribed. The relative political strength of these competing groups will not change rapidly. Small businesses have not been successful in shaping the regulations in their favor in the past. They are likely to be only marginally successful in the future, no matter how much advice Steger gives EPA.

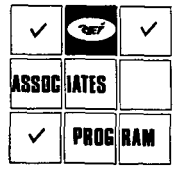
Henry Peskin makes a valid point. The census pollution abatement costs are not incremental costs caused by compliance with environmental regulations. He also agrees with me that the regulations have probably helped big firms relative to small firms. But he then goes on to venture the conjecture that, because incremental costs are relatively small, the effect of compliance costs on the distribution of firm sizes is probably smaller than I estimated.

Here again, evidence would be more useful and persuasive than words. Let us grant Peskin's assumption that incremental abatement costs are relatively small and see where it takes us. In that case, the census data on abatement costs are not really that much different from what the plants would have spent in the absence of environmental regulation. There would be no reason for the performance of the high pollution-cost industries during the seventies to have differed from that of the low pollution-cost industries.

The evidence, however, shows that in the high pollution-cost industries small plants lost share in the seventies after gaining share in the sixties, while in the low pollution-cost industries small plants gained share during the seventies. We also know that plants in the high pollution-cost industries became more capital-intensive during the seventies than in the sixties and relative to plants in the low pollution-cost industries. How are these differential changes to be explained if incremental compliance costs were relatively small? The available evidence seems inconsistent with Peskin's theory.

Every economist would like to have more and higher-quality data, and I refuse to set a precedent by announcing my contentment with the existing cost data. But those data have proved useful for classifying industries into high- and low-cost groups and for isolating differences in the relative performance of the two groups.

Peskin's last point is that moderate-size firms may be harmed most by the compliance program. I did not find such a result. But this is an interesting and plausible hypothesis and deserves further investigation. Perhaps Steger can advise EPA to fund such a study and persuade Peskin to head it up.



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Perspectives
on current developments

Karen Silkwood, Federalist

The late Karen Silkwood has been claimed for any number of controversial causes, but the most unlikely must surely be that of federalism. On January 11, however, the Supreme Court ensured that future generations of lawyers will invoke Silkwood's name to defend the prerogatives of state governments against federal preemption. In the case of *Silkwood* v. *Kerr-McGee Corp.*, the Court ruled for the first time that, even though the nuclear energy industry is already subject to comprehensive federal regulation, a state may award punitive damages in civil suits in order to penalize misconduct by the industry.

By the time the case reached the Supreme Court, it no longer bore much relation to the *cause célèbre* depicted in the movie *Silkwood.* The dramatic charge that Silkwood's death was not an accident, for example, never even made it into the trial record. Still, a bit of background is useful.

Karen Silkwood worked in a plutonium-processing plant run by the Kerr-McGee Corporation. In November 1974 routine checks at the plant found indications that she had been contaminated by plutonium. In search of the source, a company decontamination team checked her apartment and found plutonium in several rooms. Some of her personal belongings were thereupon destroyed, and Silkwood herself was sent to the federal lab at Los Alamos for medical tests. A few days later she was killed in an auto accident.

Silkwood's family filed a civil action for compensation for the harm caused to her person and property by the plutonium, and for punitive damages to penalize Kerr-McGee for the way it handled plutonium. The lawsuit was unrelated to the circumstances of her death. A jury awarded the family damages of several sorts, of which the only element that reached the Supreme Court was an award of $10,000,000 in punitive damages.

The U.S. Court of Appeals for the Tenth Circuit reversed the punitive damage award on the grounds that the federal laws that control nuclear energy prohibit states from regulating the area in any way and that punitive damages are a form of regulation. The Supreme Court, however—split along unusual ideological lines that fractured its "liberal" and "conservative" wings alike—voted five to four to reverse and remand the case to the appeals court. Justice White wrote the majority opinion supporting the award, and he was joined by Justices Brennan, Rehnquist, Stevens, and O'Connor. Justice Blackmun, joined by Justice Marshall, filed one dissent; Justice Powell, joined by Chief Justice Burger and Justice Blackmun, filed another.

There are two kinds of federal preemption of state law. The first, called occupation of the field, occurs when Congress decides that federal law should be the only regulation (or nonregulation) in a particular area. If Congress has occupied a field, a state cannot act even if there is no obvious conflict between its action and the federal regulatory scheme. The second kind of preemption arises when there is a direct conflict between state and federal law that makes it impossible for a private party to comply with both, or when the state law would frustrate the federal purpose in some other way.

The majority in *Silkwood* decided that state punitive damage awards were acceptable under both tests. It devoted most of its attention, however, to the occupation of the field test, which is a matter of interpreting legislative intent.

Just a year ago the Court ruled that Congress *had* occupied the field of nuclear safety to the extent that a state could not impose added regulatory burdens on nuclear power plants for the sake of added safety (*Pacific Gas & Electric Co.* v. *State Energy Resources Conservation and Development Commission,* 1983). The *Silk-*

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wood Court, however, rejected Kerr-McGee's contention that this precedent disposed of the punitive damages issue. It decided that although state tort remedies created some "tensions" with the federal regulatory scheme, Congress was evidently willing to tolerate them—as evidenced by the Price-Anderson Act, which contemplated civil suits against the operators of nuclear power plants. Moreover, the Court pointed out, punitive damages are a traditional part of tort law.

To some extent this part of the opinion is unexceptionable. No one had argued that people harmed by nuclear accidents should be left with no redress for their injuries, and all nine Justices agreed that Congress had not intended to preclude *compensatory* damages for such injuries.

One can also reasonably doubt that Congress intended to enact a sweeping rule that a state could *never* award punitive damages for nuclear industry misconduct, under any circumstances. For example, a state might plausibly add its own teeth to federal enforcement by awarding punitive damages for violations of federal standards. Congress might even have thought it was promoting the development of nuclear power by reassuring states that they will not lose all control once a facility is built.

Accepting that argument would mean that the relevant inquiry was not occupation of the field but conflict or frustration in the context of the specific award. This was in fact what the *Silkwood* Court decided when it said:

> We do not suggest that there could never be an instance in which the federal law would preempt the recovery of damages based on state law. But . . . preemption should be judged on whether there is an irreconcilable conflict between the federal and state standards or whether the imposition of a state standard . . . would frustrate the objectives of federal law.

Unfortunately, the Court dismissed these crucial questions in a page and a quarter. The government had argued that punitive damages conflicted with the federal scheme for remedying violations of standards, which is to impose civil penalties. The Court rejected this argument with the assertion that since it was not physically impossible for a violator to pay both fines and damages, there was no conflict. Kerr-McGee had argued that punitive damages frustrated the federal purpose of promoting nuclear energy. The Court rejected that argument as well, on the ground that Congress had disclaimed any intent to promote nuclear energy by means that failed to provide adequate remedies for those injured, and that the award of punitive damages did not frustrate its purpose as so constrained.

The majority failed, however, to discuss some of the most important issues at stake. Many federal health and safety standards represent an attempt to balance the risks and benefits of hazardous but useful activities. Extra-stringent state rules force this balance to a different point. In addition, to the extent that Congress intended to provide the industry with predictability and standardization, subjecting it to a welter of varying and unpredictable standard-setting mechanisms may itself frustrate the federal purpose.

From here on it becomes very difficult to say exactly what the Court decided. The opinion could be viewed narrowly as simply reversing the appeals court's erroneous conclusion that Congress had occupied the field completely on punitive damages. Or it could be viewed broadly—and some of its language suggests this—as endorsing the notion that the actual lower court award of punitive damages in *Silkwood* should be allowed to stand under federal law. The broader reading would have some dramatic implications for the state of the law, for reasons relating to the legal, factual, and procedural background of the case.

There are a number of grounds on which the appeals court could have reversed the lower court decision as inconsistent with Oklahoma tort law, quite aside from issues of federal preemption. For example, it could have found that the evidence was legally insufficient under state law to support the jury's conclusion on punitive damages. The record in the *Silkwood* trial contained no evidence that Kerr-McGee had been guilty of egregious misconduct and only weak evidence that the company had committed any more than minor violations of Nuclear Regulatory Commission standards. Yet the purpose of punitive damages is to punish misconduct that is either deliberate or so grossly negligent as to amount to the same thing, as well as to deter other people from following the defendant's example. (An award of compensatory damages need not imply such misconduct: even

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a careful defendant may have to pay compensatory damages for failing to control a dangerous substance, under the rule of strict liability that applies in such cases.)

Alternatively, the appeals court might have decided that a defendant who had substantially complied with a comprehensive system of federal regulation could not be found under state law to have acted recklessly or wantonly. Or it might simply have decided that the jury charge on the issue had not explained the role of federal standards clearly enough. The trial judge had instructed the jury that although the defendant's compliance with statutory or regulatory standards was evidence bearing on whether negligence had occurred, it was not dispositive of the issue. It was for the jury itself "to determine what constitutes the exercise of reasonable care in handling plutonium, or the exercise of reckless and wanton conduct, in the light of the physical characteristics of that material and the risks associated with it." This open-ended standard would be highly controversial in legal circles, for it gives considerable discretion to juries to assess punitive damages on their own.

The court of appeals was presented with all these possible reasons to overturn the lower court. But it did not reach any of them, since its decision was based on the preemption issue. Consequently, they were not really part of the case as it was presented to the Supreme Court.

Which leaves the legal question: did the Court approve punitive damages based on the trial court's charge and evidence, thus upholding a state's right to ignore federal standards in defining wanton and reckless conduct? (The dissenters seemed to think so, as they emphasized the regulatory nature of punitive damages and the amorphousness of the trial court's charge.) Or did it decide only that the Platonic idea of punitive damages did not *necessarily* conflict with the federal scheme, leaving it to the court of appeals to decide whether this *particular* charge and evidence created such a conflict? (The remand said Kerr-McGee could reassert any claims "not addressed by that court or by this opinion," and neither of these took up the permissible limits of the definition of reckless conduct.)

The best argument for the narrower view of the case is that the broader one raises too many strange questions, such as: How could Congress, in the Court's view, intend both to preempt state regulators and to let each state (and indeed, each jury) impose, retroactively, its own regulatory vision on the nuclear power industry? And, can a state now pass a law setting nuclear safety standards as long as it enforces the law by punitive damages in common law courts rather than through a regulatory commission?

Even if the opinion is read broadly, and thus raises these questions, there is reason to doubt that its impact will be as great as partisans might hope or fear. First, neither the case nor the underlying argument is over, and the appeals court may now choose to invoke some of the long-standing rules that keep juries from inventing their own legal systems. Application of such rules could greatly reduce, in principle at least, the potential for conflict between state punitive damage standards and federal health and safety standards. Second, even if Congress did not intend to *require* preemption of punitive damages in this area, the case said nothing about whether a regulatory agency created by Congress *may* preempt them if it wishes. As a general rule, agencies can preempt state law when necessary to carry out the functions Congress has given them. It is possible that *Silkwood* might allow the NRC to do this in appropriate circumstances. Similarly, any other federal agency can decide whether states frustrate its purposes when they impose punitive damages for conduct that conforms with the federal standards.

One final aspect of the decision may have more impact in the long term than the issues actually decided. A major concern underlying the formal arguments in the case is the role of juries in complex technical areas. And the four dissenters expressed very serious reservations about that role. This is an issue that has been building in American law for about ten years. Some opinions in antitrust cases have expressed concern that the issues may be so technically complicated that it is unreasonable to expect a jury to understand them. In the academic literature, there are occasional ruminations that perhaps defendants should have a right to a non-jury trial in such cases. These concerns have been increasing as the stakes in civil litigation have risen into the billions of dollars in damages, threatening both corporate survival on the one hand and fundamental regulatory policy on the other.

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The Supreme Court has never before paid much attention to these concerns. In fact, it has always been a champion of juries, insisting that they be employed even when trial and appellate courts have been skeptical. The *Silkwood* dissents may indicate that the problem is now unexpectedly open for discussion.

A Bottomless Pit for Federal Coal Revenues?

Members of Congress frequently complain that the Interior Department is failing to charge top dollar for federal coal leases. Whatever the truth of this allegation—and the recent Linowes Commission report on the subject did not find much evidence of wrongdoing—it is made more ironic by the fact that Congress itself is responsible for a number of regulations that depress federal coal-leasing revenues. Typically these regulations take the form of restrictions on how mining firms can work their leases, which lowers the price the firms are willing to pay for the leases. The Linowes Commission report cited "instances where current statutes tend to create obstacles to receipt of fair market value." And although the restrictions have a number of plausible objectives, such as preserving environmental amenities, economists are compiling a growing body of evidence that Congress has chosen some very expensive ways to buy the amenities at issue.

The best-known example may be the "diligence" requirement, under which lease holders must begin mining coal within ten years or forfeit their lease. (See Robert H. Nelson, "Undue Diligence: The Mine-It-or-Lose-It Rule for Federal Coal," *Regulation*, January/February 1983.) There are a variety of other restrictions as well, of which perhaps the most controversial has been the requirement—dating back to the Federal Coal Leasing Amendments Act of 1976—that operators achieve the "maximum economic recovery" (MER) of coal from federal leases.

A forthcoming issue of *Energy Journal* will publish an analysis of the MER controversy by William D. Watson and Richard Bernknopf, two economists with the U.S. Geological Survey. Watson and Bernknopf find that the Interior Department has been faced with an unpleasant dilemma: to apply a "strong" standard that would be economically damaging or a weak one that would render congressional intent meaningless.

Just what Congress had in mind by "maximum economic recovery" has always been quite unclear. If it means anything, it means that Congress intends to force mining companies to extract more coal than they would like—specifically, to take some seams of coal that are too deep or inaccessible to be worth taking otherwise. (In this it parallels the diligence requirement, which is meant to force mining firms to take coal *earlier* than they would like.)

Some plausible-sounding arguments for such rules will not stand up to scrutiny. It might be argued, for instance, that an MER requirement prevents "wasteful" abandonment of coal seams; but by definition the coal at issue costs more to mine than it sells for, and if it is wasteful to leave any such coal in the ground the same logic would suggest that we devote the entire GNP to reopening abandoned mines. The more persuasive arguments for MER are environmental. The theory is that if miners dig deeper they will not have to spread wider: coal from the deeper, unprofitable seams will displace coal that would otherwise have come from "lateral extension" of existing mines. This lateral extension is thought to have three major undesirable side effects. First, it disturbs more surface area, which causes one temporary disamenity (the sight of a larger strip mine) and one permanent disamenity (the land never looks quite the same even after the legally obligatory process of reclamation). Second, it requires an extension of auxiliary activities such as the building of supply roads and power lines, which do their own environmental damage.

The third side effect is more a socioeconomic externality than an environmental one. Rapid lateral exhaustion hastens the rise and fall of "boom-town" conditions in mining communities. This is alleged to impose high "infrastructure" and social-service expenditures on local and state governments, in excess, that is, of the taxes they derive from the high earnings of boom-town workers. Moreover, preexisting residents of the area may be faced with more crime and a deterioration in public services.

As Watson and Bernknopf point out, mining companies already internalize many of these costs. On the environmental side, the Sur-

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face Mining Control and Reclamation Act requires them to restore the land to an approximation of its original contours and to prevent harm to local water resources. The Federal Coal Leasing Amendments Act provides a large number of "unsuitability criteria" under which the federal government can refuse to lease land in environmentally sensitive areas. Thus the MER requirement (1) affects only the least sensitive types of land and (2) addresses only those residual environmental costs that remain after the federal reclamation requirements have been met.

Mining companies pay, directly or indirectly, most of the costs of new power lines and roads. They also pay notoriously high wages to attract "boom-town" workers, which means they are compensating at least their employees (if not the original residents) for the costs of crime and poor public services. These internalized costs already give companies a powerful incentive to slow the lateral spread of their mines.

If significant negative externalities remain, some sort of MER rule might make sense (although as Watson and Bernknopf note, it will tend to postpone the costs rather than eliminate them). But what sort of rule? The Carter administration presided over a big battle on this issue in 1979, when it issued its regulations interpreting the rules, and that battle is still having repercussions to this day.

On March 19, 1979, the Interior Department proposed to define MER as "the amount of coal that can be recovered by prudent mining practices from all seams that are *collectively* profitable" (emphasis added). This meant that a company would have to go on mining unprofitable coal seams until it had dissipated the profit from the more accessible seams. The biggest loser would have been not corporate treasuries—since they would lower their bids so as to achieve the same rate of return on a new lease as before—but federal and state treasuries, since the sale prices of federal leases would have been driven down toward zero. (States get a 50 percent share of lease revenue.) In effect, the federal government would have forgone its rent revenue on coal leases in order to discourage lateral extension. Another set of losers might have been owners of private coal tracts that are mined in conjunction with federal tracts.

The Council of Economic Advisers was on the department like a duck on a June bug. It asked Interior to commission an economic study of the regulation. Watson and Bernknopf were the ones who carried out that analysis, which later formed the basis of their *Energy Journal* article. They found that compared to a "marginal cost" rule, which would require only the mining of individually profitable seams, the department's proposed rule would have cost about $250,000 per acre saved.

The authors examined three typical coal-mining areas in the West where an average-cost rule would require the mining of more seams than a marginal-cost rule. These were areas where one seam lay atop one or more others with layers of "interburden" (materials other than coal) between them. Taken together, the three areas make up a big share (25 percent) of all federal coal in the West.

Under the average-cost MER rule, 20 percent of all coal mined from the three regions would have come from privately uneconomic seams. The increased mining costs, over and above the market value of the additional coal, would have totaled $112 million. On the benefits side, the rule would have postponed the mining of an added 456 acres of western land, accounting for seven-tenths of a mile of lateral extension. It would also have postponed for several months the eventual relocation of "boom towns" that affect the living conditions of 50,000 original residents.

The authors use the example of the Yampa/Steamboat Springs area of Colorado to illustrate how these costs and benefits would stack up in one typical area. It would make sense to apply the average-cost rule to the Yampa site if the benefits of avoiding the three kinds of externalities equal or exceed any of various possible combinations. For example, the rule would justify its cost if the benefits of averting land disturbance exceed $63,000 an acre, the benefits of averting the auxiliary costs of lengthwise mine expansion exceed $100,000,-000 a mile, and the benefits of avoiding "boom-town" costs exceed $6,000 per original resident per year. Another possible combination that would justify the rule in the Yampa case would be $100,000 per disturbed acre, $10,000,000 per mile of lateral extension, and $14,000 per person in annual boom-town costs (all figures in 1978 dollars).

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In Brief–

Unrecognized Hazards. Many discussions of job safety assume that the most lethal workplace hazards occur in manufacturing—the sort of hazards with machinery and chemicals that the Occupational Safety and Health Administration tries to reduce. Not so, according to a Johns Hopkins study of all deaths resulting from work-related injuries over one year in Maryland. The study found:

- Most of the fatal accidents (57 percent) involved vehicles of some kind: road vehicles accounted for 25 percent, non-road vehicles 16 percent, boats 11 percent, and airplanes 5 percent.
- The second biggest group of deaths resulted from shootings, mostly during holdups. Taxi drivers and storekeepers were at high risk, along with police officers.
- Overall, the riskiest job categories include those who drive on the job, those in danger of assault on the job, pilots, and farmers. Only rarely did work-related deaths result from manufacturing accidents.

In other words, most of the deaths involved either workers that OSHA does not cover or hazards that it does not address.

A Pressing Case of Discrimination. Some cities have banned "Ladies' Night" discounts at bars, and others have ordered hairdressers to charge their male clients the same fee that they charge women. Now the authorities are closing in on another group that perpetuates sex discrimination: laundries that charge more to clean women's shirts than men's shirts.

Two such offenders were recently collared by women customers in Montgomery County, Maryland, for charging $2.25 and up to clean women's shirts and a dollar or less to clean men's. The women took a sex-discrimination complaint to the Human Rights Commission in the suburban Washington county. "I think women have to wake up to some of these inequities," said one of the complainants, a sociologist with the Office of Civil Rights in the U.S. Department of Education.

Local laundries explained to the commission that their automatic presses are designed to handle the larger shirts worn by men; smaller shirts have to be pressed by hand, which can take ten times as long. A spokesman for the industry told the *Washington Post* that it is not worth spending $40,000 on special equipment for the smaller shirts because they make up only about 5 percent of all shirt-cleaning business. Some cleaners charge one of two flat rates for shirts depending on whether they fit the automatic presses or not.

Update: Pet Protection Romps to Victory. Another civil rights barrier has fallen. Elderly and handicapped animal lovers have won their historic battle to get their pets into federally subsidized housing. Some managers of such housing projects had been arbitrarily excluding furry cohabitants; pet advocates responded by introducing a bill in Congress that would ban that "form of discrimination," the proposed penalty being, as usual, a cutoff of federal funds to the offenders. (See "Pet Peeves," In Brief, *Regulation*, March/April 1983.) Although Congress was too busy to do much else in its 1983 session, it did find time to enact pet protection as part of the housing/International Monetary Fund bill that President Reagan signed November 30.

On another front, however, some elderly New Jersey residents have turned down the opportunity to live in closer harmony with the animal kingdom. The state has agreed to drop its controversial plan to require the construction of snake shelters in the middle of a retirement community. The snake-shelter plan began when the state ordered the developer of Silver Ridge West, a 400-unit retirement community, to provide a suitable habitat for two threatened species of snakes. Under its terms, the developer was to erect forty piles of pine logs and brush on the grounds of the complex.

According to published reports, residents of the development did not react to the plan with the proper preservationist zeal; in fact, they threatened to picket the governor's office to show their displeasure. The state decided to abandon the scheme when the developer agreed to buy several dozen acres of land near the complex for an alternative habitat.

These estimates may be compared with some actual estimates of externality costs by researchers in the past. One 1978 study found that uncompensated boom-town infrastructure costs ran at about $800 per person per year. Studies published in 1974 and 1980 estimate the environmental costs of strip-mining to be somewhere between one-fourteenth and one-twenty-second as high as the amounts assumed above.

The possibility might remain, of course, that some sort of MER rule might be applied selectively in order to force the recovery of just-barely-uneconomic seams for which the externality factors might be a decisive tipping factor. Watson and Bernknopf warn, however, that such a rule would be extremely difficult to apply. It would require the government to duplicate, with a high degree of accuracy, the expensive analysis that coal companies now go through before deciding which seams to mine. Moreover, even small swings in the price of coal could invalidate an analysis that applied to the marginal situations where the MER approach might make sense.

The Interior Department retreated quickly in the face of these considerations. In its final regulations of July 19, 1979, it fell back to a simple marginal-cost requirement. But it could

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do so, of course, only by rendering the statute's "maximum economic recovery" requirement essentially moot, since a marginal-cost rule merely makes mandatory what companies have an incentive to do anyway. Faced with the choice of turning Congress's language into a dead letter or wiping out the net economic value of federal coal, the department chose damage to legality over damage to substance.

Such compromises are never really satisfactory, and although this one escaped the most obvious pitfall—that is, no one sued—it has come back to haunt the coal industry. The Reagan administration, in drawing up regulations for its new coal-leasing program, has expanded the 1979 MER regulations. The thrust of the revisions is to keep the marginal-cost rule intact but to increase the burdens to companies of certifying that they are obeying it—that is, that they are indeed doing what is most profitable for them to do. In the old joke, the young mother said, "Do whatever you feel like — now let's see you disobey *that*!" At least she didn't insist on verifying compliance with her orders.

Betamax Goes Free

As Robert Goldwin has pointed out, the original Constitution (before it was amended) contained only one clause that explicitly used the word "right": Article I provides that "the Congress shall have power . . . to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."

The Founders had seemingly good reason to worry that intellectual property would be perpetually insecure in a democratic system, since its owners are so few and its consumers are so many. Little could they know that the threat to the welfare of authors might turn out to come not from politics but from the advance of technology. Such inventions as the photocopier, the personal computer, and the videotape recorder have made it easier than ever before to copy material. It is frequently contended that scholarly journals lose revenue because of mass photocopying and that classical musicians fall victim to home taping; in both cases the technology involved is so widely disseminated that the law, and the copyright owner, are virtually helpless to prevent unauthorized copying. The Supreme Court's January 17 decision in the so-called Betamax case is significant not only for its immediate effect—which is to declare legal, for the time being, at least, some home taping of television programs—but also because it may foreshadow the way the courts will handle some of the other new technologies that make copying easier.

The courts have become involved in copyright issues mostly by default, since Congress acts in this area only occasionally, after considerable pressure has built up for change. Strong discontent with the Copyright Act of 1909 arose as early as the late 1950s, but Congress dawdled until 1976 before finally making its revisions. A major sticking point was Congress's inability to determine the proper copyright treatment of a new technology, cable television.

When home TV taping arose in the mid-1970s, therefore, it was only natural that Universal Studios and Walt Disney Productions, two Hollywood firms with valuable film properties to protect, should decide to seek a judicial rather than a legislative remedy. In 1976, apparently concluding that it would be both politically and logistically difficult to seek damages against ordinary users for taping programs at home, the two firms instead sued Sony, then the largest manufacturer of video recorders, along with Sony's advertising agency, a number of retail dealers, and a token consumer. In addition to seeking damages for past infringements from all parties except the token consumer, the studios sought an injunction against the manufacture and marketing of recorders and blank tapes. They may have hoped that in lieu of such an injunction the court would require the makers of recorders and tapes to negotiate with copyright holders for production rights. Alternatively they might have hoped that the Court would impose on the manufacturers a blanket licensing arrangement similar to that now used to collect revenues from cable television systems when they retransmit distant broadcast signals (see Henry Geller, "Making Cable TV Pay," *Regulation*, May/June 1981).

The trial court rejected the Universal/Disney claim, but the U.S. Court of Appeals for the Ninth Circuit found Sony to be liable and remanded the case for a determination of relief.

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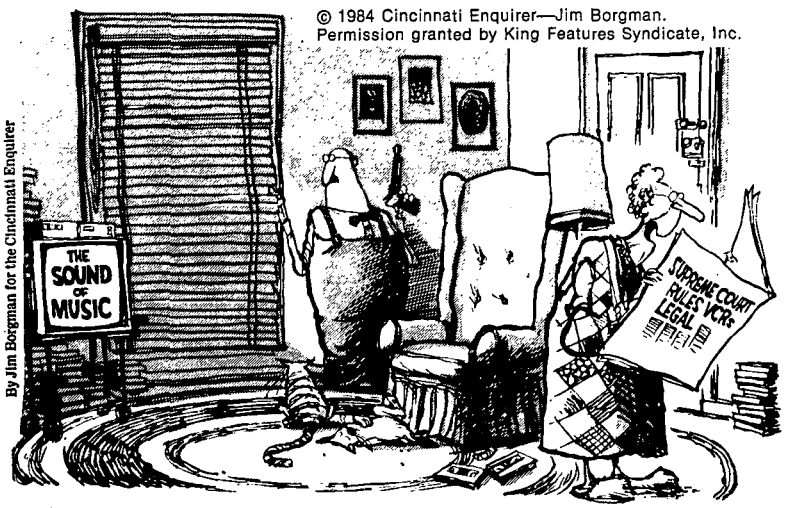
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By Jim Borgman for the Cincinnati Enquirer
THE SOUND OF MUSIC
SUPREME COURT RULES VCRs LEGAL
"NO MORE PACKING IN THE MIDDLE OF THE NIGHT! NO MORE RUNNING FROM THE BETAMAX PATROL! HERBERT, DARLING, WE'RE CLEAN!"

By a five-to-four vote, however, the Supreme Court reversed the court of appeals (*Sony Corporation of America et al.* v. *Universal City Studios, Inc., et al.*). The Court found that Sony was not a contributory infringer because videotape recorders are capable of "substantial" noninfringing uses of two kinds. First, the machines can be used to record noncopyrighted material such as home movies. Second, and more controversial, the owners of videotape recorders do not, in the Court's view, violate copyright law when they record broadcast programs simply in order to watch them at a more convenient time. Because of these noninfringing uses, the Court held that, even though certain home taping might be an infringement, liability could be imposed only on users, not on the maker of the machine.

Article I may have invited Congress to make authors' rights "exclusive," but lawmakers and the courts have carved out numerous exceptions. One such exception is the doctrine of "fair use," which permits copying for such purposes as scholarship and news reporting. Congress has been silent, however, on whether home recording of television programs constitutes fair use. And as so often happens, both sides felt free to interpret the lawmakers' silence in accord with their own views. "One may search the Copyright Act in vain," said the majority opinion, "for any sign that the elected representatives of the millions of people who watch television every day have made it unlawful to copy a program for later viewing at home, or have enacted a flat prohibition against the sale of machines that make such copying possible." The minority drew just the opposite inference from the legislators' silence. "When Congress intended special and protective treatment for private use . . . it said so explicitly."

Was the Owner Harmed? The Court distinguished two reasons why viewers tape programs off-the-air. One is "time-shifting," in which a viewer records a program, watches it at a more convenient time, and then usually erases it by recording another program on the same tape. The other is "library" use, in which a viewer records a show and keeps it on the shelf, expecting to view it more than once and perhaps show it to friends and neighbors. Building a library is more expensive than time-shifting, since it means buying more and more blank tapes as time goes on.

The majority found that most recording was for purposes of time-shifting, and that the plaintiffs had "failed to demonstrate that time-shifting would cause any likelihood of nonminimal harm to the potential market for, or the value of, their copyrighted works." This question of burden of proof may be one of the more significant aspects of the decision. The majority opinion places the burden on a copyright holder to prove that it has been harmed. It says that "the concept of 'fair use' requires . . . the copyright holder to demonstrate some likelihood of harm before he may condemn a private act of time-shifting as a violation of federal law." The dissent, on the other hand, would have put the burden on the user to demonstrate that "he had not impaired the copyright holder's ability to demand compensation from (or to deny access to) any group who would otherwise be willing to pay to see or hear the copyrighted work." The difference is important in principle, since it might be hard to prove either case.

The evidence of harm that the majority sought was limited to any reduction in advertising revenues caused by off-the-air taping. It agreed with the trial court in rejecting the movie studios' contentions that measured ratings would decline or that the audience for re-

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runs would fall. "Harm from time-shifting is speculative and, at best, minimal," it found. Indeed the majority could point to statements by the plaintiffs that no actual harm had actually occurred.

Aside from the fact that limiting the search for harm to the advertising market increases the likelihood that no harm will be found, it should also be noted that in 1976, when the case was brought, fewer than 50,000 video recorders were in use in the United States. The present figure is about 10 million and some projections are that the number will grow to 50 million by 1990. It is not altogether surprising that it was hard to detect any reduction in advertising revenues in the years just after recorders were introduced. Somewhat amusingly, Sony was able to point to statements from copyright owners such as the sports leagues that they were unconcerned with the off-air tapings of their programs. More recently, some of these same interests have changed their tune, perhaps because of the large increase in the number of recorders.

What Sort of Harm? The Court split sharply on the question of what constitutes harm to a copyright holder. The majority seems to think that a copyright holder is harmed only if its revenues actually decline, while the minority holds that harm occurs if copying prevents the owner from exploiting new markets. These would include not only markets such as those for pre-recorded tapes, but also the market for the service of "time-shifting" itself—since that is a service that viewers would presumably be willing to pay for.

The dissent drew a distinction between "productive" copying that leads to "external benefits from which everyone profits" (such as copying for purposes of criticism or comment), and copying that is done "for the sole benefit of the user." It added that it knew of no case in which the latter had been held to be fair use. It did concede, however, that some *de minimis* "nonproductive" uses do not harm the author so that, in those cases, because "no purpose is served by preserving the author's monopoly . . . the use may be regarded as fair."

Should Manufacturers Be Held Liable? The plaintiffs argued that Sony and its codefendants were contributory infringers because they had sold the recorders knowing that their principal use would be off-air taping. Indeed, Sony's advertisements had prominently described such uses. Sony responded that it could not be held liable because its product was a "staple article of commerce" that could be put to a variety of uses, not all of which involved infringement. Examples are recording of noncopyrighted broadcast programs or of private or family occasions.

Bringing suit against the manufacturer of the copier itself, while not without precedent, is highly unusual. Book publishers have brought actions against photocopy shops whose business relies heavily on illegal copying. But no publisher has ever tried to sue Xerox or Canon for supplying the machines.

The division in the Court on this issue turned on the distinction between the actual and potential uses of the machines. The majority said that Sony could escape liability if its machines were *capable* of "substantial" noninfringing uses, while the minority said that such uses had to be "significant" in actual practice. Since the trial court had not ruled on the factual question of whether the noninfringing uses were significant (it had declared that taping for time-shifting was fair use), the minority would have sent the case back for further consideration on that question.

It may be argued that the scope of the Betamax decision is limited, since it applies only to off-air taping of "free" broadcast television programs for purposes of time-shifting (it does not, as the minority points out, establish whether viewers may legally tape cable or pay-TV programs). Moreover, the Court seems to have reserved its right to ban time-shifting if copyright holders can prove harm in some future case. Some of the Court's language, however, is rather ominous for owners of intellectual property. The Court seems to be inviting "noncommercial" users to infringe on a copyright unless the holders can demonstrate harm —and it may demand that that harm consist of cutting into the existing profits of producers, not just depriving them of opportunities for additional profits. It is reasonable to predict, therefore, that other "noncommercial" users will begin testing the limits of the new doctrine, and that the Court will have to return to this subject again.

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Viewpoint

William R. Havender

EDB and the Marigold Option

IN RECENT MONTHS we went through yet another in that parade of hysterias over a carcinogen in the nation's food supply that began with the great cranberry scare of 1959. This time the threat was a grain fumigant, EDB. As before, the hysteria was fueled by the ambitious actions of state health officials, the inaccurate and inflammatory rhetoric of self-styled "environmentalists," and the media's willingness to take the environmentalists at their word while treating their opponents as already convicted. Extremists controlled the momentum of these events, and they ultimately succeeded in forcing Administrator William D. Ruckelshaus of the Environmental Protection Agency (EPA) to declare an emergency ban on all uses of EDB in grain processing. This decision, as we shall see, recklessly tosses dice with the nation's health.

Does EDB cause cancer in laboratory animals? No knowledgeable person denies this, since all ten long-term, high-dose tests, involving both sexes of both rats and mice and two routes of exposure (oral and inhalation) were unequivocally positive, as was a skin-painting test on mice. Clearly, EDB must be handled with care. But does this mean that the traces now being found in supermarket foods pose a significant hazard to the public and warrant a ban? Not at all, and here is why.

EDB's Risk to Humans

Let us begin by looking at how much EDB people are getting from their food. According to EPA's estimates, the average person consumes 5 to 10 micrograms of EDB a day—a quantity far too small to be seen with the unaided eye. (By comparison, we typically ingest 140,000 micrograms of pepper each day.) It is less than a quarter-*millionth* of what, on a body weight basis, the rats were given. In other words, one would have to eat at least 250,000 times as much food every day over a lifetime as we normally do to equal the dose that produced cancer in laboratory animals. This huge difference, dwarfing even the 1,000-bottles-of-diet-pop-a-day equivalent human dose that made the saccharin rat tests look ridiculous, is itself enough to justify skepticism about the reality of the hazard faced by consumers.

[EPA's] ban on all uses of EDB in grain processing . . . recklessly tosses dice with the nation's health.

Of more direct concern is the question of how much *carcinogenic risk* 10 micrograms of EDB a day actually poses to the public. According to EPA's estimate of September 27, 1983, as many as three extra cases of cancer could result among 1,000 persons exposed to typical dietary amounts over a lifetime, a number that has dominated the public debate. At first, this sounds startlingly high, but it diminishes substantially on reflection. For example, our lifetime risk of cancer is already 300 in 1,000, since about 30 percent of us can expect to get cancer at some point in our lives; thus three extra cases per 1,000 translates into a *relative* increase in cancer risk of 1 percent, that is, only one-thirtieth of the cancer risk posed by the cigarettes that are also sold in supermarkets and much too small to be readily detected by means of epidemiology. Another comparison is that the incremental lifetime risk of death from

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taking up jogging (mainly from heart attacks) is five per 1,000, or nearly twice that from consuming EDB.

It is more important, however, to remember that EPA's 1983 estimate is derived entirely by extrapolating from animal bioassays using *hypothetical* assumptions (such as that the relation between carcinogenic response and dose remains linear over the full 250,000-fold dose range, that rats and humans are similarly sensitive, et cetera) that sorely need to be tested against real human data. Happily, we have such data, since EDB has been around a long time. There are two studies of workers engaged in the manufacture of EDB who were exposed to doses some 5,000 to 10,000 times higher than typical consumers for periods up to sixteen years or more. A third study, reported in 1979, took the statistical model EPA was *then* using to extrapolate animal risk to humans and applied it to estimate the cancer rate expected among workers from the animal test results. The predicted incidence of cancer came out ten times higher than that actually observed, which actual rate was not significantly different from that expected in an unexposed population. To be sure, the number of workers was not large, so it would be incorrect to jump to the conclusion that EDB is absolutely safe at low levels. But the number was large enough to reject the ten-fold elevation in cancer incidence predicted from the animal results: more than half the workers, after all, would have been dead from cancer if the prediction had been valid! Since then, EPA has changed its statistical model to be more "conservative" (that is, to yield still higher estimates of risk), and it is this newer version that was used to generate the estimate of three per 1,000. We are safe, then, in saying that this estimate greatly overstates the true risk and must be reduced by a factor of at least ten, to 0.3 per 1,000.

That is still not insignificant, but it concerns the lifetime risk from a lifetime of exposure—and, we might ask, what about the *short-term* risk, say, over a few months? This is pertinent, since Florida, in declaring an "emergency" and issuing immediate stop-sale orders, claimed that the short-term risk was intolerable. This risk is easy to calculate. Assuming linearity of the dose response and an average lifespan of seventy years, the increase in risk from just the next three months (a period adequate to allow the responsible regulatory and congressional bodies to hold hearings and convene meetings of scientists to discuss sensible tolerance levels and safe alternatives) would be $0.3/(4 \times 70) = 0.00107$ per thousand, or about one in a million. Clearly, no "emergency" existed.

Two other considerations also argue that the risk from current average levels of EDB in food is negligible. One is that in 1982 California reduced the allowed levels of EDB in inhaled air to which workers may be exposed from 20 parts per million (ppm) to 130 parts per billion (ppb), a reduction of more than 100-fold. As a result of the extensive hearings California held on this matter, 130 ppb was accepted as the level believed to be safe, with a generous margin of prudence, for workers to breathe in all day, every day, for their entire working life. Note that 130 ppb in air translates into about ten *milli*grams per worker per day. This dose, which was believed safe, mind you, is 1,000 times larger than the ten *micro*grams the average consumer is estimated to get. While one obviously cannot simply apply safety standards appropriate to workers (typically consisting of healthy males in the prime of life) to the diverse population at large (which includes the elderly, the sick, children, pregnant women, and so on), a factor of 1,000 is more than adequate to allow for this diversity. Thus, current average levels of exposure do seem quite safe.

The other reason for not going into a panic over EDB-contaminated food is that its risk vanishes into insignificance against the background of risks from other, *natural* carcinogens in food. Pepper contains safrole, for instance, and pepper extracts have caused cancer in mice. Back-of-the-envelope calculations of pepper's carcinogenic "potency," combined with the daily dose humans ingest (about 140 milligrams a day), show that pepper's risk to consumers is roughly ten to one hundred times greater than that from EDB residues in food. And aflatoxin, a mold contaminant present in many of the same grain-based foods as EDB (as well as in peanut butter, milk, and apple juice) is some 1,000 times more potent than EDB as a carcinogen. Its allowed level in solid food is 20 ppb, which means that consumers are exposed to as much as 20,000 times the carcinogenic hazard from aflatoxin that they would get from

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EDB present in foods at 1 ppb (the "emergency" action level of Florida and some other states). And this does not include the risks from the large amounts of highly carcinogenic hydrazines in certain types of edible mushrooms, the carcinogenic psoralens in celery, the carcinogen allyl isothiocyanate in mustard, and many others. Against this natural background of dietary carcinogens, the risk from ten micrograms of EDB a day is utterly trivial. Indeed, a simple calculation shows that the estimated carcinogenic hazard from this amount is one-fifteenth that from drinking a twelve-ounce saccharin-sweetened diet soda each day.

Against this natural background of dietary carcinogens, the risk from ten micrograms of EDB a day is utterly trivial.

Put another way, a muffin baked from the most highly contaminated muffin mix found in California (which had 5.4 ppm of EDB) would have only a fraction of the carcinogenic hazard of a peanut butter and jelly sandwich made with peanut butter containing aflatoxin at the perfectly legal level of 5.4 ppb. This level would pose the same cancer risk as the muffin *mix* containing 5.4 ppm of EDB, but a muffin baked from this mix would have only about one-tenth this amount, because most of the EDB bakes off. Since a single muffin weighs roughly about as much as the couple of spoonfuls of peanut butter in a typical sandwich, it is obvious that the sandwich poses much the greater risk. If one can eat that sandwich with equanimity—and most of us don't think twice about doing so—then one should be at least as tranquil eating corn muffins, even those made from the most highly contaminated mix that has been found in California.

The Risk of Banning EDB

Now let us turn to Mr. Ruckelshaus's decision on February 3. It consisted of two basic components, one Solomonic, one demonic. The Solomonic part was to set tolerance levels that provide more than an adequate margin of safety to the public and yet are readily achievable by industry.* This is evident from the fact that the bulk of the grain-derived food currently on supermarket shelves is *already* in compliance with these levels; only a small fraction of the food samples in Florida and California exceed them. The few samples falling above 150 ppb are clearly "outliers," no doubt attributable to accidents or negligence rather than to intractable technical difficulties. The primary change needed to eliminate these outliers is for companies simply to monitor EDB levels, which they have not done heretofore because no standard was in effect. The incentive to do such monitoring is exactly what Mr. Ruckelshaus's recommendations will provide.

But the second part of Mr. Ruckelshaus's decision—an emergency open-ended ban on *all* uses of EDB for fumigating grain and milling machinery, however carefully monitored and controlled—is far more sinister. This action is not merely unwarranted by the level of risk involved, but as we shall see is downright dangerous.

No one so far in our hungry world has seriously recommended that we simply let vermin eat up our grain. We will have to use something to control the insect problem in stored grain. Mr. Ruckelshaus's ban, effective the day it was announced, is already forcing us to use substitutes that are available *now*, and the fact is that there are only a few efficacious chemicals currently registered for use as grain fumigants. It is important to assess the hazards they may pose to workers and consumers and, in particular, to learn whether they have been thoroughly tested in the same sort of long-term, high-dose animal cancer tests that revealed the cancer hazard of EDB. This is an essential consideration, since if we ban EDB specifically because of its cancer risk, we certainly do not want to replace it with something that will be just as bad—or perhaps even worse—in this same respect.

In terms of their effectiveness, phosphine and methyl bromide are the preferred alternatives now available. Both work reasonably well in bulk fumigation, but neither is suited for the "spot" (local) treatment of milling machinery. This is because they are more volatile than EDB

* The levels are 30 ppb in ready-to-eat foods such as breads and cereals, 150 ppb in foods that have to be cooked (flour and muffin mixes), and 900 ppb in raw grain.

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(they are gases at room temperature, while EDB is a liquid), and for this reason escape from the machines before a toxic level has been reached that can kill the insects. So the only way to use these substances to kill the bugs inside the machines is to fumigate *the whole mill.* Rather than just a few gallons of fumigant being needed for the spot treatment of machines as with EDB, many thousands of gallons are necessary to bring the overall concentrations in the mill high enough to sterilize the machinery. And this should be done each month, since the generation time of the insects is about four weeks.

As it happens, this change of operation greatly increases the hazards to workers. Methyl bromide is not only much more toxic to humans than EDB, but it is also odorless (unlike EDB) so that workers do not have a fail-safe warning when a leak inadvertently occurs. Phosphine, too, is more poisonous to workers than EDB, and in addition is highly flammable. This latter property is of utmost concern since grain dust, itself highly explosive, is endemically present in grain bins and mills. (By contrast, both EDB and methyl bromide are flame-retardant.) Thus, substituting these substances for EDB ineluctably raises the risks to the workers who must use them.

There are those in this utilitarian world (I am not among them) who might argue that this would be a small price to pay if the risks to the vastly larger number of consumers were substantially reduced. But this is where we meet the final irony. For phosphine has not been tested for carcinogenicity *at all,* and if we decided today to do so, it would take at least three years before we could have secure assurance that phosphine was not a carcinogen. And methyl bromide is currently under test, with the results expected to be announced this March. For structural reasons, by the way, it is highly likely that methyl bromide will turn out to be a carcinogen.** Of the two most likely alternatives to EDB, then, we cannot now confidently state that either of them is any safer than EDB in terms of cancer-causing potential. Indeed, both could be worse.

** A paper has just appeared that describes the results of a cancer test in rats on methyl bromide. The substance is indeed a carcinogen, with a potency similar to that of EDB. (See L. H. J. C. Danse, F. L. van Felsen, and C. A van der Heijden, in *Toxicology and Applied Pharmacology,* February 1984.)

A third, less effective alternative sometimes mentioned is a four-to-one mixture of carbon tetrachloride and carbon disulfide. Carbon tetrachloride is a carcinogen, and carbon disulfide, if used by itself, is explosive.

Now, it could turn out that, precisely because methyl bromide and phosphine *are* much more volatile than EDB, it will be possible to get rid of all traces of these residues from consumer products—in which case it might not matter whether they are carcinogens or not. But the same thing was once said about EDB, and it could just as easily turn out, as it did with EDB, that a fraction of these gases binds tightly to the surface of the grain in a manner that prevents it from easily passing off. Such tendencies might depend, as with EDB, on the particular type of grain being treated, its moisture content, the temperature of storage, and other factors. In any case, we would need to *know* just how much of these residues survive processing for each type of grain and end up in consumer products, before we could confidently state that consumer safety would not be worsened by the use of these alternatives. In my inquiries, I was unable to discover that this necessary testing had been done.

In short, Mr. Ruckelshaus's ban guarantees greater hazards to workers, even while, perversely, it cannot guarantee that the public's exposure to potent carcinogens will actually be lowered. In trading EDB, whose cancer risk we know to be exiguous, for substances whose risks are unknown, Mr. Ruckelshaus is playing dice with the nation's health.

. . . we are almost certainly standing at the beginning of a short line of dominos that will fall, one by one, to a regulatory ban as more information about their risks becomes known.

Moreover, we are almost certainly standing at the beginning of a short line of dominos that will fall, one by one, to a regulatory ban as more information about their risks becomes known. Methyl bromide, for example, was already undergoing preliminary EPA review in 1980 and carbon tetrachloride was then being scrutinized in the full RPAR process (rebuttable presump-

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tion against registration), suggesting that these alternatives are vulnerable to being banned in the near future. If so, we would have only phosphine left, whose flammability is high and whose carcinogenic hazard is unknown.

Of Men and Marigolds

Now one would have thought that the matter of comparing the cancer risks of EDB and its replacements would have constituted the central part of EPA's regulatory decision process. Yet it was virtually absent. EPA's Position Document 4 (the 286-page official documentation of the agency's regulatory stance regarding EDB), while dwelling at length on EDB's cancer risks, does not refer *even once* to the fact that no information at all is available on the potential carcinogenic properties of methyl bromide and phosphine.

Nor is this dearth of serious interest in the cancer hazards of alternatives restricted to EPA. As it happens, I have had the chance (while taking part in broadcast debates on the issue) to ask several leading spokesmen what they would use instead of EDB. Dr. Samuel Epstein, professor of environmental medicine at University of Illinois Medical Center in Chicago, leaped eagerly to respond, confidently naming carbon disulfide (the explosive that can only be used in mixture with a carcinogen) and aluminum phosphide (which, when mixed with water, generates phosphine, the intensely flammable gas whose cancer activity is completely untested). Al Meyerhoff, representing the National Resources Defense Council, responded to the same query by offering methyl bromide (under test currently, results not yet known) and aluminum sulfide (which is neither a fumigant nor an insecticide). When I ventured to suggest that perhaps he meant aluminum *phosphide*, he resolutely insisted that he meant what he said. And Mr. Hugh Kaufman, who bills himself as the "whistleblower" of EPA, replied by naming (I hope, dear reader, you are sitting down), "Marigolds"!! As it developed, he had confused grain fumigation (the topic of our debate) with *soil* fumigation to kill nematodes (root worms) in citrus groves, and somewhere he had heard the theory that marigolds planted between the trees could keep the worms away.

Though this was irrelevant to the matter of grain fumigation, I was intrigued. Here, it seemed, was the answer to the dreams of both the environmentalists and the citrus growers. So I called an expert nematologist to track this matter to its root. It turned out that this story originated in a report from South Africa, where fields that had been single-cropped with a species of *Tagetes* (marigold) were found to have reduced levels of nematodes the next year, apparently because the nematodes could not complete their life cycle in the roots of this species. But nematodes, unlike earthworms, do not move very far in soil, so *Tagetes* has little or no effect when interplanted with other crops. More significant, *Tagetes* is shallow-rooted and has no effect at all on nematodes at deeper levels where the bulk of the citrus tree roots are. And most significant of all, the species of *Tagetes* that has this property is not the common garden marigold we all love, but a thoroughly noxious weed native to South Africa that is banned in the United States!

Now *that* episode truly *is* emblematic of the thoughtlessness with which environmentalists and regulators have approached the question of safe alternatives to EDB, and a fortiori the question of the consumer's net safety. With thinking of this quality dominating decision making and the public debate, we are hopelessly fated to end up, as the fumigants remaining to us are banned one by one, with nothing better than the aluminum sulfide of Mr. Meyerhoff and the marigolds of Mr. Kaufman. ■

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Eighth Annual

December 1984

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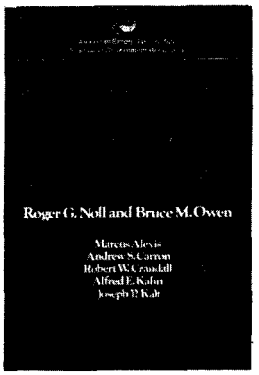

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'ROUND AND 'ROUND ON RPM

Should a manufacturer be allowed to set the price at which a retail store can sell its product? The Supreme Court decided in 1911 that it should not: under the Sherman Act, the Court said, that sort of "resale price maintenance" (RPM) is illegal. Later, in the mid-thirties, Congress passed legislation permitting states to legalize RPM by passing "fair trade" laws. It withdrew that permission in 1975.

Recently, the Supreme Court's flat ban on resale price maintenance has come under increasing fire from economists and antitrust enforcers. The critics argue that in many, or even most, instances the practice is a spur to competition and efficiency rather than a restraint. Both the Justice Department and the Federal Trade Commission proposed last fall that the ban be lifted in favor of a "rule of reason" test—under which courts would judge the competitive impact of RPM on a case-by-case basis. Congress countered in November by passing an appropriations rider that bars the Justice Department and the FTC from spending funds on any activity intended "to overturn or alter the per se prohibition. . . ." The Court is addressing some aspects of the RPM controversy in the case of Monsanto *v.* Spray-Rite, *which it now has under review.*

The essays that follow are adapted from a colloquium held during AEI's Public Policy Week in December 1983. The authors offer recommendations on how to treat RPM—ranging all the way from per se legality (Frank Easterbrook) through rule-of-reason (James C. Miller III) to the current per se illegality (Robert Pitofsky). First, however, Phillip Areeda sets the stage with a discussion of some of the legal and historical issues at stake in the controversy.

Marvin Kosters,
Director of AEI's
Government Regulation
Studies

The State of the Law

Phillip Areeda

MY PURPOSE HERE IS to outline the legal background of "resale price maintenance"—a practice by which a supplier dictates the prices charged by dealers reselling his product. I will attempt to do so with the Olympian detachment for which Harvard is, of course, so famous—and leave the nitty-gritty of whether the practice is good or bad to my colleagues Frank Easterbrook, Robert Pitofsky, and James Miller III.

I can present this issue in terms of two tensions in the law, created by two pairs of legal rules. One tension is that between the Supreme Court's decisions in *Dr. Miles Medical Co.* v. *John V. Park & Sons Co.* (1911) and in *Continental T.V.* v. *GTE Sylvania* (1977). The second tension—which is not directly involved

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in the legal status of resale price maintenance but which, as a practical matter, may be fundamental—is that between *Dr. Miles* and *United States* v. *Colgate* (1919) as to when two parties can be found to have conspired in restraint of trade.

THE POSITION of U.S. antitrust law on resale price maintenance was set by *Dr. Miles* in 1911. The Supreme Court held that resale price maintenance arrangements constitute "unreasonable restraints of trade" and are therefore categorically illegal. The Court rested on two interrelated factual (or economic) premises for that decision. The first premise was that a "vertical" price-fixing agreement between a manufacturer and its dealers on the price the latter would charge for the manufacturer's product has the same market impact as a "horizontal" agreement among the dealers themselves to fix that price. Both kinds of agreements, the Court said, eliminate price competition among retailers selling that brand. Given that horizontal price-fixing among the dealers of a product was, and is, illegal per se—that is, illegal always (or virtually always)—the Court reasoned that vertical price-fixing ought to be governed by the same rules.

The Court's second, and related, premise was that retail price-fixing does not serve any legitimate interest of the manufacturer. In other words, once the manufacturer sells its product to a wholesaler, it should have no interest in what happens to the product further down the distribution chain. The manufacturer, as the Justices put it, "having sold its product at prices satisfactory to itself, the public is entitled to whatever advantages may be derived from competition in the subsequent traffic."

The next three articles will agree that the Court's two premises, at least so categorically stated, were wrong. Vertical price-fixing *is* different from horizontal price-fixing, and the manufacturer *does* have an interest in some circumstances in what happens down the distribution chain. However, there is one telling point to be made in defense of the Supreme Court's *Dr. Miles* ruling: though economically wrong, it was probably historically correct. Over the years, the primary impulse for resale price maintenance has come from organized retailers, such as the National Association of Retail Druggists. Although they might have been motivated by the desire to prevent "free riders" (which my colleagues will describe), I am willing to make the broad-brush judgment that their main purpose was to eliminate competition among themselves. This does not necessarily mean that resale price maintenance is always an instrument of dealer market power. But the Supreme Court of 1911 was responding to its own identification—and probably an accurate one—of the dealer interest the practice was serving at that time.

Following the *Dr. Miles* decision, other distribution restraints were examined in terms of how closely they resembled resale price maintenance. When a manufacturer limited the territories in which his dealers could sell or the customers to whom they could sell, the prosecutors argued that this elimination of competition among dealers in a given brand should be subject to the same per se rule outlawing resale price maintenance. This argument essentially succeeded in *United States* v. *Arnold Schwinn & Co.* (1967), in which the Supreme Court came very close to declaring such territorial and customer restrictions automatically unlawful, too. However, ten years later in *Sylvania,* the Court overruled *Schwinn* and held that customer and territorial restrictions were to be judged on their merits in each case according to the "rule of reason." The cases that have come after *Sylvania* have generally been very hospitable to customer and territorial restrictions and have generally ruled them lawful.

The apparent state of the current law on this issue is that resale price maintenance is unlawful per se, while customer and territorial restrictions are governed by the rule of reason —which has amounted almost to per se legality.

... the kinds of justifications offered for customer and territorial restrictions ... are comparable, though not necessarily identical, to the kinds of justifications offered for resale price maintenance.

Clearly there is tension between these two propositions, at the level of both principle and litigation. The tension at the level of principle

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is that customer and territorial restrictions eliminate competition among dealers who sell a particular brand no less than does resale price maintenance. Furthermore, the kinds of justifications offered for customer and territorial restrictions—for example, the manufacturer's "legitimate" interest in preventing free riders—are comparable, though not necessarily identical, to the kinds of justifications offered for resale price maintenance. Indeed, it is often argued that *Sylvania*'s hospitality toward customer and territorial restrictions should make resale price maintenance legitimate as well. The Supreme Court may further enlighten us this spring in the pending case of *Spray-Rite* v. *Monsanto*, but so far it has been willing to live with this tension. In upholding customer and territorial restraints in *Sylvania*, the Court said explicitly that it was not changing the rule on resale price maintenance.

At the level of litigation, the tension manifests itself in the following way. Suppose that a manufacturer of personal computers believes that selling computers requires special promotional effort in showing customers how the computer works, differentiating it from rival products, and the like—all of which is expensive. Suppose also that the manufacturer's Chicago dealer decides to sell by mail. As a result, a customer may shop at a Boston store, take the time of the sales people there, get their advice, and then buy from a mail order house at a lower price—which the latter can afford because he does not have sales personnel demonstrating the product. The Boston dealer complains to the manufacturer, who anticipates that continued mail order operations would impair future sales and so stops selling his product to that Chicago dealer. The latter then initiates an antitrust suit alleging (1) that the manufacturer terminated him because he undercut the price of the Boston dealer and (2) that this amounts to vertical price-fixing, which is unlawful per se. The manufacturer characterizes his behavior as a customer or territorial restraint to be tested by *Sylvania*'s more hospitable rule.

Of course, both statements—apart from their legal conclusions—are true. Clearly, the practice is both a way of controlling resale price and a way of implementing a restrictive distribution policy. And the curiosity of this legal situation in which *Dr. Miles* and *Sylvania* exist side by side is that the law is simultaneously uttering two propositions that the layman, uninstructed in the law's fine distinctions, might regard as inconsistent. The lower courts have enormous trouble applying this pair of legal rules, because virtually any customer or territorial restriction, presumptively lawful, will have a price effect, presumptively unlawful. Whatever one might think of the wisdom of condemning resale price maintenance, it is evident that we need to define more precisely than the law now does when and how those rules apply.

The lower courts have enormous trouble applying this pair of legal rules [Dr. Miles and Sylvania], because virtually any customer or territorial restriction, presumptively lawful, will have a price effect, presumptively unlawful.

LET ME NOW ILLUSTRATE how this confusion is magnified by the second tension I mentioned, the one between *Dr. Miles* and the *Colgate* case. Price restraints are condemned by Section 1 of the Sherman Act only where they are embodied in a "contract combination or conspiracy" between two parties. That requirement is satisfied when a manufacturer and dealer agree on the resale price that will be charged. But *Colgate* posed the following issue: Suppose the manufacturer simply says to the dealer, I don't want an agreement or a promise, I just want you to know that if you charge less than a dollar for my toothpaste or whatever, I won't supply you with any more of it. In short, the manufacturer uses the threat of termination to enforce a "unilateral demand." The *Colgate* case held that resale price maintenance brought about

. . . it may strike the lay mind as somewhat odd that a result achieved by a promise is unlawful while the very same result achieved by a threat . . . is allowed.

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through mere threat or mere termination was not an agreement. I will not pursue the merits of the decision except to note that it may strike the lay mind as somewhat odd that a result achieved by a promise is unlawful while the very same result achieved by a threat of termination is allowed.

Many judges have also thought it odd. The *Colgate* rule has been so widely eroded that most lower courts—the Supreme Court has not spoken definitively on this—hold that a manufacturer reinforcing any kind of restricted distribution policy by terminating recalcitrant dealers has "conspired" with somebody. Now observe the consequences of pressing this idea. It is generally supposed that a manufacturer can choose, if he wishes, to sell his goods at wholesale to Saks Fifth Avenue and not to K-Mart because he thinks Saks will best preserve the image he wants for his goods. But suppose that Saks decides overnight, in a change of corporate management, to become a K-Mart. When the manufacturer ceases to supply the transformed Saks, it will sue, claiming that the manufacturer is practicing resale price maintenance. And many courts would so hold.

There is a further wrinkle that is involved in *Spray-Rite.* Recall my computer example. When the mail order house starts selling computers at discounted prices in Boston, the Boston dealer complains to the manufacturer that before long it will not be able to afford to demonstrate the product anymore. If the manufacturer cuts off the mail order house, the latter will allege, among other things, a conspiracy between the manufacturer and the complaining dealer. (I put aside the metaphysics of what a conspiracy means between the manufacturer and a third party that has no influence, control, power, domination, or ability to give a relevant quid pro quo to the manufacturer.) The legal issue is now couched in terms of whether a conspiracy can be found between the manufacturer and the complaining dealer.

This conspiracy issue, as well as the *Colgate* problem, makes it unclear what a manufacturer may or may not do. One could resolve the uncertainty by extending *Sylvania* to resale price maintenance and testing all distribution restraints according to the rule of reason. Short of that, one could define more precisely what constitutes an agreement. Uncertainty would be reduced by confining *Dr. Miles* to cases where manufacturers specified prices in a relatively clear-cut way and enforced them through agreement or perhaps even through threat of termination, and thereby excluding my hypothetical Saks case or my hypothetical computer case.

THIS SUFFICES by way of introduction and leaves to my colleagues in this colloquium to discuss the differences between horizontal and vertical agreements, the kinds and persuasiveness of justifications for manufacturer restrictions on distribution, and the ancillary dangers that resale price maintenance will promote either dealer power or collusion among manufacturers.

The answers will prove to be quite complex. For example, the free-rider concern is real, but the desire to preserve product image may be the more important explanation. Perhaps, consumers ought not to be deprived of images, but protecting image may not be a sufficient virtue to offset the danger that resale price maintenance may be serving anticompetitive dealer interests. To be sure, an organized dealer cartel can be prevented. But there may be other forms of dealer pressure which cannot independently be forbidden or prohibited under the statute. Or a manufacturer, anticipating dealer pressure, may adopt resale price maintenance without any observable dealer action that the law can deal with.

The difficulty of resolving these questions makes it tempting to rely on such easy answers as "Congress has already decided" or "let the market rule." But in repealing an antitrust exemption for state-approved resale price maintenance in 1975, Congress decided only that resale price maintenance will be governed by federal antitrust law as distinct from state law. Congress left the content of that federal law where it has always been, namely in the hands of the courts. Nor does the "unrestrained" market rule universally. Antitrust law allows manufacturers to restrain dealer freedom in many ways—by, for example, specifying hours of operation, minimum inventories, or warranty service requirements. Of course, there are reasons to distinguish different kinds of restraints, as my colleagues in this colloquium will now proceed to do. ■

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Restricted Dealing Is a Way to Compete

Frank Easterbrook

NEITHER RESALE PRICE MAINTENANCE nor any other restriction adopted by a manufacturer for its dealers should be a subject of serious antitrust attention. It should make no difference whether the manufacturer prescribes territories, customers, quality standards, or prices. It should make no difference whether the restrictions are set by contract or by manufacturers' ownership of the retail outlets, the most "extreme" form of control. They are all the same.

This is not a radical proposal. Most of these practices—which I lump under the term "restricted dealing"—are in common use. All of them except the prescription of prices are dealt with under a highly deferential standard of review and are lawful except in the rarest of cases. The treatment of prices is an anomaly that should be brought in line with the treatment of vertical integration and other restrictions on distribution.

The treatment of prices is an anomaly that should be brought in line with the treatment of vertical integration and other restrictions on distribution.

If restricted dealing arises out of a cartel among dealers or manufacturers, by all means let us prosecute. Cartels are unlawful per se and should remain so. But restricted dealing is not often used by cartels, and most of it is just a way by which one manufacturer competes with others. Our economy has many ways of assembling and distributing products. The more routes to market, the broader the consumers' choice. The broader their choice, the better off they are. Cartels restrict rather than increase the range of choice. We should welcome restricted dealing as a benefit to consumers and not lump it with cartels, with which it has nothing in common.

Frank Easterbrook is professor of law at the University of Chicago and former deputy solicitor general of the United States.

LET US BEGIN AT THE BEGINNING, with the purpose of antitrust. The antitrust laws are a prescription for consumer welfare. They exist to stop trusts or cartels from reducing the output of goods and services. The reduction brings about monopoly prices, the conspirators' goal. It also causes a misallocation of resources, as people shift to things that seem "cheaper" but really cost society more to produce in order to get the same level of satisfaction.

Cartels cooperate to cut output. Yet other forms of cooperation are procompetitive. All large firms entail a great deal of cooperation. Within Ford Motor Co., the engine and body divisions cooperate, and someone "dictates" a price at which things will be sold. The firm dictates to a plant manager what to make and how. Sears tells its store managers what to sell and at what price. Antitrust law tolerates, indeed encourages, such agreements. Agreements like these create the goods and services we value.

Just as there can be cooperation within a firm, so there can be beneficial cooperation across firms. Restricted dealing is a form of cooperation. One firm (the retailer) agrees to

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do things the way a manufacturer specifies, just as an employee does things within an integrated firm. The agreement is not a displacement of the market. Such contracts are the market at work. All contracts restrain in the same sense that restricted dealing restrains.

Why, then, should cooperative agreements in the chain of distribution be subject to antitrust scrutiny? The usual reason given is that restricted dealing is "like" a cartel in the sense that firms agree on price (or quality, or place of distribution). True enough. But one can find such agreements inside every firm too. The fact that two practices have such a feature in common is just the beginning of analysis.

Before going on, I want to put to rest a line of argument one hears too often in political discourse. It is that restricted dealing, and especially resale price maintenance, is bad because it enables manufacturers to jack up the retail price of its products. So it does. Resale price maintenance is no different in this respect from other restrictions (for example, if there are fewer dealers, each can charge more).

So what? If Lacoste wants its shirts, with the little crocodile emblems, to sell for $50 each, it can achieve this easily enough. It may raise the wholesale price, or it may improve the product's quality or style. The observation that these things influence retail prices is not even interesting as an antitrust concern. Every manufacturer may sell what it wants and charge what the traffic will bear. Other manufacturers, perhaps those using dragon emblems, may sell different goods and charge less. This is competition. Consumers will choose. The question is whether restricted dealing affects price in an *anti*competitive way. If manufacturers may affect retail prices by changing wholesale prices or quality, why may they not affect prices through restricted dealing?

THE ARGUMENT MUST be that restricted dealing can facilitate a real cartel, such as an agreement among manufacturers or dealers to charge an elevated price. One of the cartel arguments might run like this. Dealers—say, druggists—in some city collude to drive up the price of toothpaste. Each dealer is worried that the others will "cheat"—that is, that other dealers will reduce the price in order to make additional sales at the expense of those adhering to the fixed price. So the dealers conscript the manufacturers to help them out. The manufacturers set a fixed resale price and penalize dealers that sell at a lower price.

The argument that restricted dealing is a way of enforcing a dealers' cartel conceals substantial problems. First, the industry must be one in which the dealers can form a cartel. But when will this be? Most retail markets have free entry, and retailing is about as close to an atomistic market as you get. There is a drug store on every other corner. There are so many retailers (and potential retailers) of toothpaste and other consumer goods that the firms could not form or sustain a cartel with or without the aid of manufacturers.

As for the manufacturers, why should they go along? What's in it for them? A manufacturer that helps dealers form a cartel is doing itself in. It will sell less, and its dealers will get the monopoly profits. Manufacturers could be "paid" in higher wholesale prices for cooperating, but that would increase the incentives of dealers not to join the cartel—to cheat by buying the product at a lower price and selling on a lower margin. If significant numbers of dealers cheat, bye bye cartel.

It won't do to get just one manufacturer of toothpaste to adopt restricted dealing. All or almost all must do so. If there are holdouts, noncooperating dealers can sell the holdouts' products for less, and that would destroy the cartel. Yet why would all manufacturers want to go along? It pays one or more to hold out. Dealers could conscript all manufacturers only when the conditions of a manufacturers' cartel existed.

Things are just as bad if the manufacturers make slightly different products. One manufacturer may hang back by setting the cartel price, but changing what it supplies for the price. It may put more paste in the tube, or use a formula that requires less paste per brushing. Differentiated products spoil the use of restricted dealing to enforce a cartel.

Then there is a problem of verification. Why are manufacturers any better at policing prices than fellow dealers are? The cheating dealer cannot attract extra business without advertising its lower prices. Then its fellow conspirators learn in the same way manufacturers do, and they could enforce the deal themselves. The extra enforcement from the threat

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of cut-off by the manufacturer may be too late, or too little.

So the dealers' cartel explanation will not amount to much unless there are (1) few dealers, (2) few manufacturers, (3) homogeneous products, and (4) easy policing. If we see many dealers and many manufacturers, we can exclude the cartel possibility. And if we see some manufacturers using restricted dealing while others do not or if we see substantially differentiated products, we can exclude the cartel hypothesis no matter how many or few dealers and manufacturers there are.

The conditions for restricted dealing to be a useful part of a dealers' cartel just do not exist very often. (I could show the same for the use of restricted dealing as part of a manufacturers' cartel, but that is unnecessary. The argument proceeds in the same way.) We do not condemn business practices under the antitrust laws unless they are anticompetitive in a given case or unless—in the case of per se illegality—they are so likely to be anticompetitive that detailed investigation is unnecessary. The conditions under which restricted dealing is anticompetitive are rare, and automatic condemnation would pick up far too many procompetitive examples to be worthwhile.

IN ORDER TO MAKE HEADWAY in understanding restricted dealing, we must ask why a (sane) manufacturer would ever set up a system of distribution in which the *dealer* obtains the benefits of higher prices. The manufacturer wants to get its product from plant to customer. To do this, it "buys distribution." The difference between the wholesale and retail price is the "cost of distribution." If the manufacturer can create distribution more cheaply than other dealers, it will integrate and save this expense (although it incurs the new expense of operating a retail division). When Sears owns a store, the cost of distribution is the price of land, fuel, and staff, the same things an independent retailer must cover. Sears, like the nonintegrated firm, wants to hold this cost as low as possible.

The manufacturer's interest is the same as the consumers'. Both want to keep this cost down. For a given retail price, the manufacturer wants the highest wholesale price. For a given wholesale price, it wants the lowest retail price in order to sell more units. The manufacturer looks out for the consumer here, just as it does in picking the materials out of which to build the product. Few believe that manufacturers pay "too much" for their raw materials or labor—or that, if they did, this would be an antitrust problem. Yet critics of restricted dealing apparently accuse manufacturers of ill-serving their own interests when they buy distribution services. What can be going on?

Few believe that manufacturers pay "too much" for their raw materials or labor —or that, if they did, this would be an antitrust problem. Yet critics of restricted dealing apparently accuse manufacturers of ill-serving their own interests. . . .

The essential point about restricted dealing is that these contractual provisions do more than just get "a product" from plant to purchaser. They affect what the product *is*. The manufacturer is buying something of value to itself and to consumers.

Some attributes of a product can be installed at the factory. A TV comes with a 19-inch tube or a 25-inch tube built in. Some attributes are added later on. Information is one. How do you use a computer? How do you connect one part to another? The manufacturer can "build in" some information by putting booklets in its boxes, but it can also supply information via trained salesmen. The more ways there are to do this, the more likely each consumer will find some satisfying combination of product attributes.

Look at the market in computers. There are at least four ways to sell machines, four different combinations of hardware and information. One combination is that the manufacturer puts a machine and a book in a box and sells the combination. The retailer sells the closed box, with minimal additional demonstration. If you don't like it or find that you can't make it work, you can take it back. That's the end of the service. Commodore, in conjunction with retailers such as K-Mart and Toys-R-Us, has followed this strategy with great success.

The second combination is to do what Radio Shack has done, to own some stores and franchise others. Then you can furnish special

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information and display services in your own stores. Radio Shack charges for the service by setting a higher price. The problem with this arrangement is that the consumer cannot easily compare one brand against another and so may not appreciate your machine; worse, the costs of single-brand selling may be higher.

IBM has taken a third path, opening product centers that display its machines. A customer can learn all about the IBM's abilities and what products work in what ways with what peripherals. IBM charges for its information through the wholesale price to independent dealers, where consumers can compare different brands. This strategy works, though, only when the manufacturer has a very large volume. Other manufacturers do not sell enough to justify opening special stores.

These are the only combinations that work well in a world without restricted dealing. Restricted dealing adds a fourth option, which Apple Computer and others seem to be pursuing. Apple places its computers in retail stores, requires the dealers to display them and provide extensive information and knowledgable support. It has no stores of its own. Such a method of distribution is very hard to sustain without restricted dealing, for the reasons Phillip Areeda gave. The customer may soak up all that information in the "full-service" store and then order the computer from a mail-order outlet. It then becomes difficult for a dealer to recover its costs, since it cannot charge by the hour for presale advice. Competition from low-service outlets—so-called free riders—slowly undermines the full-service stores. The drain of sales to low-service stores is a kind of tax on presale information. The tax leads to too little being provided, as consumers see things.

Restricted dealing makes it easier for manufacturers and dealers to pursue this fourth option, the option of full-service outlets by sellers too small to justify vertical integration. If all dealers charge the same price, the customer will go to the one with better service, just as the manufacturer intended. Or if the dealers are placed far apart, each must compete for customers (against the products of other manufacturers) by supplying better information and service.

Restricted dealing is procompetitive because it increases the number of ways manufacturers can compete to provide what some segment of the population wants to buy. The more ways there are to slice up the product-service continuum, the more likely any one customer's wants will be met. Banning any restricted dealing practice necessarily reduces the number and effectiveness of options available to consumers.

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IF RESTRICTED DEALING is indeed beneficial to consumers, it should be possible to observe the benefits. Several scholars have analyzed instances of resale price maintenance from the years when federal law authorized states to permit the practice within their territories. These studies showed that the resale price maintenance states had higher retail prices, lower sales per store, and more retail business failures. These conclusions often are cited to condemn restricted dealing, but in fact they support the thesis that consumers benefit.

The finding that prices are higher with restricted dealing is no surprise. The manufacturer cannot get a store to supply information for free. The question is whether the consumers value the new combination of product, information, and service they receive by at least the amount of the price differential. (I come back to that.)

The finding that sales per store drop with resale price maintenance is exactly what one expects if the mechanism promotes the provision of personalized information and service. These special services are more likely to come from smallish stores (hi-fi outlets, corner druggists) than from mass merchandisers.

The finding that the rate of business failure among stores is higher with resale price maintenance also supports my approach. Restricted dealing promotes a particular form of competi-

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tion among dealers. If the dealers are smallish, this competition leads to a relatively larger number of failures. On the other hand, if restricted dealing comes about as part of dealers' cartels—or if it increases dealers' profits in some other way—we expect to see relatively fewer business failures among dealers. We see more failures, so we know competition has become more fierce.

What of other evidence? We would like to know effects on output. If the new information and product tailoring is worth the higher price, then sales will rise despite the increase in price. Market shares of those who use restricted dealing will rise relative to those who do not. If restricted dealing is anticompetitive, sales and shares will fall.

The evidence from the famous cases is illustrative. In the *GTE Sylvania* case, the defendant manufacturer's market share rose consistently after it adopted the challenged practices. In the *Spray-Rite* v. *Monsanto* case, now before the Supreme Court, Monsanto's market share and sales took a dramatic upturn at the time it adopted its practices. The list can be extended.

A more general study backs up this impressionistic information. John P. Gould, now dean of the Graduate School of Business at the University of Chicago, is at work on a large-scale study of restricted dealing in liquor. The variation among state laws provides a natural laboratory for analysis. Dean Gould's data show that the use of restricted dealing is associated with a 10 percent or greater increase in sales, after all other plausible contributing factors have been held constant. Restricted dealing also appears to go hand in hand with a rise in the rate of introduction of new brands.

The evidence is not definitive. Evidence never is. But the evidence is consistent with the theory. It is hard to point to any case in which restricted dealing has injured consumers. It is impossible to tell a coherent story under which restricted dealing does so frequently. Antitrust law therefore should leave manufacturers free to adopt such practices as they choose. Competition, not the courts, best corrects the mistaken judgments of manufacturers. ■

Why Dr. Miles Was Right

Robert Pitofsky

IT STRIKES ME THAT when debaters agree on basic premises but disagree on major conclusions—which is the case in this colloquium—it is worth asking why. I would suggest that there are two considerations that split those who want vertical price-fixing to remain per se illegal from those who would make it virtually per se legal. One has to do with whether they take a static or dynamic view of supplier-distributor relationships; the other has to do with whether they recognize the practicalities and limits of the litigation process.

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Let me begin with what I think is a premise that we appear to share. When a manufacturer-supplier sets the resale price to the dealer, it is doing something that, on the face of it, is rather odd. Ordinarily, it would seem, a supplier has everything to gain from fierce and vigorous competition among its distributors. After all, it has already received the wholesale price for its product, and the lower the retail price, the more likely the product will sell. So, why does the supplier not sit back and let its dealers cut each other to shreds?

There are four possible explanations. The first is dealer pressure on the supplier, either overt or anticipated, to participate in what is, in effect, a dealer cartel. The second explanation

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is that vertical price-fixing is a stabilizing technique for supplier cartels: without it, suppliers will cheat on their cartel by cutting prices in the expectation that dealers will pass the price cuts on to consumers and thereby increase total demand for the product.

A third explanation, the one that Frank Easterbrook emphasizes, is that the supplier decides that its dealers have the wrong mix of price and service and that it can increase its product sales by inducing the dealers to supply more service. This strategy requires controlling the dealers' minimum prices in order to keep some dealers from undercutting the price of those that are more service-oriented and becoming—a fashionable word these days—free riders. In dealing with this situation, which I believe is quite rare, the key question is whether the supplier can serve its legitimate business interests in ways that avoid vertical price-fixing and the anticompetitive effects that come along with it.

The fourth explanation, one that has received less attention in the literature, rejects the premise so often asserted in debates over resale price maintenance—the premise that the manufacturer has no interest in its dealers' prices. I will argue that if one takes a dynamic rather than a static view of relationships between manufacturer-suppliers and their dealers, it becomes clear that the manufacturer-supplier has an interest in the price at which its dealers sell.

NOW LET ME TAKE these explanations one at a time. The first, that dealers press the manufacturer to support a dealer cartel, is hard to document. Vertical price-fixing has been illegal since 1911, and horizontal dealer cartels have been illegal even longer, so there is little point in taking a survey to see how often dealers try to induce vertical price-fixing to achieve dealer cartel effects. Also, dealer pressure can be applied in subtle ways that need not involve overt or coordinated demands. Nevertheless, there is good reason to believe that such pressure exists. For one thing, we find historically that vertical price-fixing has occurred most frequently in industries having well-organized dealer trade associations—indicating that the pressure for resale price maintenance is exerted upward from the dealers rather than downward from the supplier. For another, dealers have a strong incentive to induce the manufacturer to participate in their cartel. Assume that ten dealers in Jordache jeans in an area—high-priced, service-oriented dealers—want to set a price of $32 but that three of them refuse to go along. That cartel is very unlikely to work, because the three will cut prices and increase their sales at the expense of the seven. But if the supplier can be persuaded to participate as a cartel-enforcer, then the three will be denied the product and the dealers that do go along will police each other's prices. The result is a dealer cartel that is stable and therefore effective.

Incidentally, it is a bit misleading to suggest, as Easterbrook does in his essay, that antitrust should be indifferent to vertical price agreements because the same effects are observed in vertically integrated firms. Horizontal price effects can be observed in firms as well—for example, General Motors sets the prices on Pontiacs and Buicks with some view toward coordination. But that is hardly a reason to ignore horizontal cartels between independent competitors.

The second explanation is that suppliers use resale price maintenance in order to enforce their own horizontal price-fixing. While virtually all agree that this happens occasionally, I tend to agree with Easterbrook that it does not happen often. It would require that all the suppliers have similar prices and that the market be rather concentrated—but in fact resale price maintenance is attempted in many markets where neither of these conditions applies. In any event, since this situation certainly does not in itself justify per se illegality, I will forgo extended discussion.

The chief alternative explanation, to which I now turn, is that the manufacturer is somehow the ally of the consumer and that both want the same thing—the proper mix of price and service. Both Easterbrook and Phillip Areeda mention the case of computers, stereos, and the like, and I agree with them that resale price maintenance on such products may not be, on balance, anticompetitive. Consumers shopping for such complex products often collect brochures, information, and advice from the fashionable service-oriented store and then go across the street to Bell or K-Mart and make their purchase at (say) half price. Manufacturers faced with that situation may indeed

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have a procompetitive motive for vertical price-fixing. I will deal in a moment with how I think the law should treat such cases.

But, as for situations where salesperson explanation is not the service the supplier desires, consider what the explanation really suggests. A manufacturer decides its dealers should be supplying more service. But instead of discussing that with the dealers, instead of contracting with the dealers to provide the service, instead of providing the service itself, the manufacturer imposes vertical price-fixing. And it does this confident that the dealers will know that it wants them to respond by offering specific services—for example, a longer warranty or point-of-sale advertising. So the manufacturer fixes the retail price and, presto, the dealers come up with the right service in the right amount at the right time.

In my view, that scenario is nonsense. In the real world, if suppliers want more advertising or more generous warranties, they and their dealers draw up a contract specifying the terms of a cooperative arrangement or the suppliers provide the services themselves. There may be some services that are difficult to arrange by contract because the transaction costs are so high, but those cases would be extremely rare.

Even if suppliers do occasionally attempt to induce service competition by imposing vertical price restrictions, the question remains whether, as a matter of policy, that should be allowed. Today retailers offer a rich variety of price-service options, ranging from cut-rate no-frill operations to high-priced "prestige" outlets with a lot of services. If we should now permit suppliers to fix resale prices for all stores that sell their product, we would in effect be turning over to the suppliers the decision on the amounts and kinds of service that are needed. It is far better, in my opinion, to leave that decision to the free market. I would add another point. One of the most annoying aspects of this debate is the assumption that the seller with the lowest price offers the least service. It seems to me plausible to assume that discounters often are more efficient and, through price-cutting, pass that efficiency along to consumers. A rule permitting vertical price-fixing (a per se legality rule) would deny the dealer the ability to pass efficiencies along to the consumer—which would, I think, discourage the generation of the efficiency in the first place.

One of the most annoying aspects of this debate is the assumption that the seller with the lowest price offers the least service. It seems to me plausible to assume that discounters often are more efficient and, through price-cutting, pass that efficiency along to consumers.

Let me also compare the arguments that we have heard with reality. The principal argument made by Easterbrook and others who support his view is that the manufacturer's motive is to mix service and price, and that service will not appear in the market because of the free-rider problem. But think for a moment about the product areas in which resale price maintenance has appeared—boxed candy, pet foods, jeans, vitamins, hair shampoo, knit shirts, men's underwear. What are the services we are talking about in these cases? Take jeans. What services does Saks Fifth Avenue provide that K-Mart does not? In both stores, the jeans are laid on the table, customers take them to a dressing room, try them on, and buy them. Is it really plausible that Jordache is fixing the resale price at $32 and denying the product to K-Mart in order to induce Saks to promote services on jeans? I think not.

Clearly the strongest argument against my position is one that Easterbrook mentioned. Where the supplier who engages in vertical price-fixing has only a small market share and its competitors do not also use vertical price-fixing, is it likely that resale price maintenance is induced by dealers to support dealer cartels—and hence is not related (or rarely related) to the service explanation? The problem with that argument has to do with market definition. Take jeans again. Levi and Jordache are in the same market. But that does not mean that the dealers of each branded product have no interest in eliminating intra-brand price competition. Remember, we are talking, for the most part, about retail trade in highly differentiated, highly advertised products. Thus, the dealers of each brand can lose market position and lose profits as a result of competition among themselves, even though they are in some sense in the

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same market with other groups of dealers specializing in other brands.

Let me turn briefly to the fourth explanation for resale price maintenance—one that challenges the premise that the manufacturer does not care what the resale price is. Let us take the jeans example again, and assume that Jordache charges a wholesale price of $18, that Saks sets a retail price of $32, and that K-Mart then obtains a supply of the jeans and sells them at $22. Is it true that Jordache is indifferent to such price-cutting except to the extent that it inhibits services? I think not, because in the long run Jordache will not be able to hold an $18 wholesale price if the Saks price falls from $30 to $27 to $24. What I am saying is that, in long-run dynamic terms, there is a combination, a partnership, between the supplier and the high-priced dealer, and the supplier knows it.

To SUM UP, I see no justification for resale price maintenance, based on the service rationale, except in the stereo-audio-computer type of situation where manufacturers probably have a legitimate need to establish resale prices. The challenge is to find a way to accommodate this need.

One possibility, of course, would be to convert the per se illegality rule handed down in the *Dr. Miles* case, which Areeda explains in his essay, to a full rule of reason. My problem with that is the practical one: in this area, a full rule of reason would ensure lengthy and expensive trials. The key question at issue in determining whether to permit a particular instance of resale price maintenance would be market power, and that involves definition of relative market, as well as analysis of entry barriers, potential and existing competition, production capacity, and on and on. As virtually every antitrust lawyer knows, such cases can be made to be extremely expensive and are generally won by the defendant. In other words, rule of reason treatment would probably amount to per se legality, and it would be instituted just to take care of a situation that rarely comes up—the one where the manufacturer desperately needs specific dealer services that cannot be secured in any other way.

In others words, rule of reason treatment would probably amount to per se legality, and it would be instituted just to take care of a situation that rarely comes up—the one where the manufacturer desperately needs specific dealer services that cannot be secured in any other way.

A more sensible approach, I submit, would be to retain the rule of per se illegality and graft onto it a few narrow factual defenses. For example, we could permit a new entrant to use vertical price-fixing, briefly and in a limited way, to get started in a market in which services are important. We could also permit something in the nature of an exception, as we do in the field of horizontal price-fixing, where a product could not exist in the marketplace at all but for the price restriction. With the burden of proof firmly on the defendant, resale price maintenance might be permitted if the defendant could show that a serious free-rider problem was inhibiting its ability to compete and that vertical price-fixing was the best way to eliminate the free-rider problem.

In short I propose a carefully defined exception, usually of limited duration, to the present rule of per se illegality. Now, one might ask, is that all this argument is about? What a tempest in a teapot! But I suggest that the difference between a per se rule with carefully defined exceptions and a full rule of reason is not a tempest in a teapot. As some evidence for the point, let me cite the fact that in the three years since the Antitrust Division and the FTC decided that vertical price-fixing should be treated under a more lenient approach, not per se illegality but a rule of reason, the number of vertical price-fixing cases brought by the two agencies has fallen from an average of about ten a year to zero.

That suggests what the situation would be if we were to make the proposed shift to rule of reason treatment official. Government authorities, acting with the best of will, would rarely find a case they were confident they could prove. Hence, the difference between per se illegality and rule of reason treatment would be, I think, a difference of basic doctrine. Under rule of reason treatment, vertical price-fixing would almost never be illegal at all. ■

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An Analytical Framework

James C. Miller III

RESALE PRICE MAINTENANCE (RPM) is a subject that is easily misunderstood and, perhaps for that reason, highly controversial. It is difficult for someone who favors a per se lawful standard, or even a rule-of-reason test, to counter the seductive argument that a ban on RPM promises lower prices. But with this issue, as with so many others in economics, what seems apparent at the surface is not necessarily what is true.

I would like to make two points. First, briefly—and without adding more examples to those given by Professors Areeda, Easterbrook, and Pitofsky—I am firmly convinced that resale price maintenance *can* be procompetitive. Arguably, a reading of the Sherman Act would say that antitrust enforcement officials should not act in those instances. But there are also instances where, as Pitofsky points out, the practice can be at least an instrument of collusion, of restraint of trade. In my opinion, antitrust enforcement officials should pursue these cases with vigor. So, resale price maintenance can be either good or bad, depending on the circumstances, and law enforcement officials might well tailor their policies accordingly.

RPM can be procompetitive not only because of the free-rider problem discussed in the preceding essays, but also because at times a company may need to find a particular price-quality niche in a market. Too often, I think, antitrust officials treat a market as homogeneous when in fact it is quite heterogeneous. For example, the research that my colleague on the Federal Trade Commission, George C. Douglas, and I undertook into the propensity of airlines to engage in non-price competition left me fully persuaded that in many markets there are price-quality tradeoffs and that filling niches in the market can make the overall market more competitive (*Economic Regulation of Domestic Air Transport: Theory and Policy*, 1974).

For example, a new entrant in a market or even an existing firm may be able to achieve a different price-quality option most efficiently by engaging in RPM. On this point, I disagree with Pitofsky's position that it is almost always more efficient for a firm to achieve the preferred set of qualities to go along with the sale of its product by writing contracts than by engaging in RPM. In other words, resale price maintenance can simply be a more efficient way for a manufacturer to elicit from its dealers the combination of product and service qualities that consumers prefer—a combination that may be more apparent to the dealers than to the manufacturer and that individual dealers may well tailor in different ways for their particular markets.

The second point I would like to make is the importance of developing a more sophisticated analytical framework for analyzing RPM standards. Recall that there are at least three standards from which to choose: a per se unlawful test, which is currently the law of the land; a per se lawful test, which is supported by some academics and practitioners; and the rule-of-reason test, which itself comes in various gradations. Associated with these three standards are costs for consumers and taxpayers. The accompanying diagram is useful for exploring how enforcement officials can maximize consumer and taxpayer welfare by minimizing the sum of those costs.

There are two kinds of cost that directly affect consumers. One is the cost to consumers

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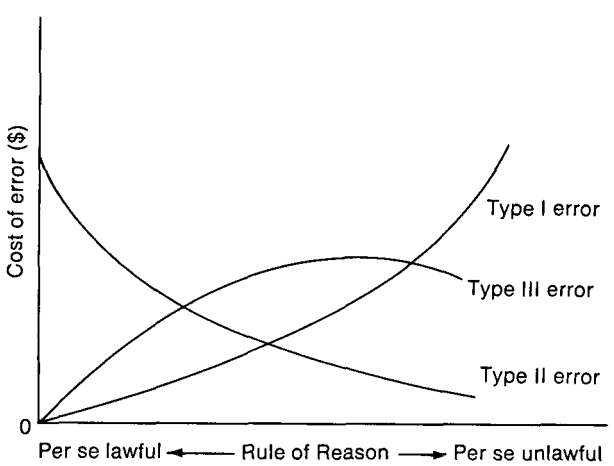
that occurs when antitrust officials allow anticompetitive RPM to take place. The second is the cost to consumers that occurs when antitrust officials suppress instances of procompetitive RPM.

The diagram shows the costs of different degrees of legal stringency on resale price maintenance, from a per se lawful test at the extreme left to a per se unlawful test on the extreme right. In between, on a continuum, are various forms of the rule-of-reason approach. The right side might be characterized as *Dr. Miles* without any exceptions. One might imagine moving leftward from that position by introducing *Colgate* and other specific exceptions such as those advanced by Pitofsky. Toward the left side of the diagram one approaches the positions articulated by Easterbrook, as well as federal appeals court judges Richard Posner and Robert Bork.

Suppose now that the Federal Trade Commission or the Department of Justice is considering a business practice that is alleged to be a case of resale price maintenance. Our first concern is with stopping anticompetitive behavior. But recall that we also want to avoid restraining procompetitive behavior. With these two concerns in mind, it is obvious that we could make two types of errors, which I refer to here as Type I and Type II errors (in keeping with a distinction in the statistics literature). A failure to allow procompetitive RPM to go forward is a Type I error; a failure to restrain anticompetitive behavior is a Type II error.

Under a per se unlawful approach, Type II errors would be minimized, but at a cost of maximizing the Type I errors—banning all procompetitive instances of RPM. The per se lawful approach would have exactly the opposite problem, since it would permit instances where RPM is anticompetitive. Thus the cost of Type I errors rises, and the cost of Type II falls, as one moves from a per se lawful approach through the continuum toward a per se unlawful approach.



The perfect answer to the RPM problem might therefore seem to be simply a matter of adding the two curves vertically and noting the point of minimum cost. For a truly optimal enforcement strategy, however, we should also consider litigation costs, which are ultimately borne by taxpayers and consumers. In this regard, it is important to note that businesses need guidance from legislative and law enforcement officials concerning what is permissible and what is not. For lack of a better label, let us call these litigation and uncertainty costs borne by taxpayers and consumers a Type III error.

Type III errors will be zero under a per se lawful standard, since there will be no litigation. They will be somewhat higher under the per se unlawful standard, because there will be, as there is today, litigation over whether a challenged business practice is or is not a case of RPM. And they will be highest under a rule-of-reason standard, because there will inevitably be disagreements over whether particular instances of RPM are lawful, and thus more litigation than with either kind of per se test.

The ultimate quest of antitrust policy makers, of course, would seem to be to find the point where the sum of all three types of error is at a minimum. This would represent the standard leading to maximum consumer and taxpayer welfare. Finding this optimal legislative-enforcement standard for RPM will require empirical work to determine the shapes and positions of the lines in the diagram. Moreover, we should consider refining this analysis to take into account cases of anticompetitive RPM *not* detected by enforcement officials and cases where because of uncertainty about prosecution firms decline to engage in procompetitive RPM. And then there is private-sector enforcement of RPM to consider!

Let me stress again that I do not have simple answers to these empirical questions. Rather, my purpose is simply to suggest an analytical framework in which to couch the debate on this issue—and thus to help us move beyond mere anecdotal evidence and sloganeering. ■

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The Elusive Carrot: Tax Incentives for R&D

Kenneth M. Brown

AMONG ITS MANY PROVISIONS, the 1981 Economic Recovery Tax Act created several new incentives for industrial research and development. The most important of these was something of an innovation: a tax credit for firms that *increase* their R&D spending. Unfortunately, as sometimes happens when government uses finely tuned regulations to influence private behavior, this provision has some unintended consequences that are undercutting its worthy objective.

The provision was meant to induce firms to increase their R&D spending at minimal cost to the Treasury—that is, without giving them large tax concessions or subsidies. The idea, as one prominent economist put it, was to "make [companies] run like hell but never let them get more than a little bite of the carrot." Instead, the carrot disappeared in one gulp. The provision went into effect after a resurgence of R&D was well under way and therefore became more of an after-the-fact bonus than an incentive. What happened was like a greyhound race in which the hounds catch the mechanical rabbit, savage it, and then race on. What's worse, if the rate of R&D should begin to slow, as it well might, this particular credit is more likely to speed the decline than retard it. Finally, because the credit is temporary (it expires December 31, 1985), it is having little effect on companies' long-term R&D planning and therefore provides little evidence to help policy makers judge its usefulness.

Congress must soon decide whether the credit should be extended, modified, or dropped. Let us hope that this time around it decides to dispense with carrots and sticks and chooses instead to establish the stable, predictable policy environment that industrial innovation needs in order to flourish.

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Economic Growth and R&D Trends

When Congress was considering R&D tax credits back in 1980–81, its main concern was the poor performance of the U.S. economy during the 1970s. The productivity figures were dismal, and other nations seemed to be catching up with us technologically. It was natural for policy makers to see inadequate R&D spending as one source of these problems. To begin with, few relationships in economics are as widely accepted as that between technological progress and an economy's long-term performance. Furthermore, numerous studies have linked productivity and growth—of both individual firms and entire nations—to the amount of R&D performed. Examples of technical change surround us, and practically all of them started with someone, somewhere, performing scientific research. Thus there is a clear line of causation from research to innovation to economic progress, even if it is impossible to quantify the

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relationships with precision. This does not mean, of course, that every dollar spent on research "input" will necessarily pay off in any clear economic benefit or "output"—a point to which I will return.

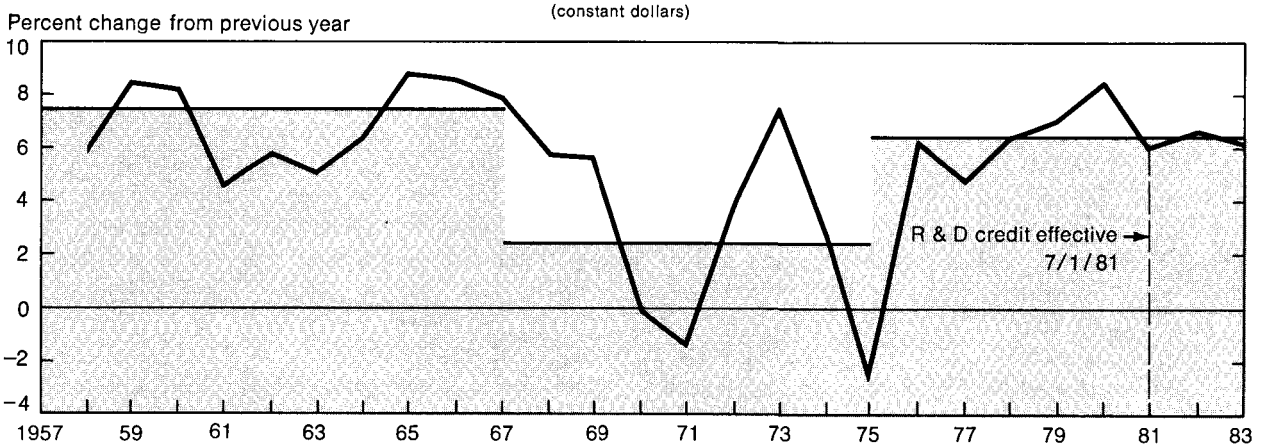
The U.S. economy is particularly dependent on innovation. We devote a higher portion of our gross national product to R&D than almost any other country and consequently lead in many high-tech industries. In 1983 our R&D spending exceeded $86 billion, of which slightly more than half came from industry, about 3 percent came from nonprofit institutions, and the rest from government.

But R&D spending, especially the industry part, is cyclical, as the chart below reveals. Thus, measured in constant dollars, industry spending on R&D grew by 7.5 percent a year between the mid-1950s and 1967—a pace well in excess of general economic growth. In the years 1968 to 1975, however, the rate of R&D growth slowed to 2.5 percent; and since federal funding (not reflected in the chart) actually *fell* by 2.7 percent a year over this period, clearly the nation's stock of scientific knowledge was not growing as rapidly as in the past. Then, industry spending seemed to recover, growing by 6.6 percent a year in the 1976–80 period. The greatest surge came in the two years just *before* the Economic Recovery Tax Act was enacted—7 percent in 1979 and 8.4 percent in 1980.

That strong performance apparently made little impression on the Congress that added R&D tax credits to the 1981 act. Given the suddenness of the earlier slowdown, it seemed premature to deduce from only a few years of data, some of it preliminary, that the earlier growth trend had resumed. In addition, *basic* research, which some analysts believe is even more important in the long run than the development and commercialization stages of the innovation process, was still considerably lower as a fraction of total R&D than in the 1960s. Third, Japan and other nations had apparently taken the lead in certain areas of technology, and their success imparted a "more is better" flavor to our own policy debate, regardless of whether the slump in R&D spending had ended. Finally, there was (and still is) legitimate concern over the accuracy of the data, especially as regards the price of R&D. National Science Foundation research suggests that the price of R&D has risen faster than the GNP deflator (used in this article and by others), meaning that the 1968–75 slump in R&D activity was worse than the data indicate.

Quite aside from the role of technology in maintaining U.S. growth and competitiveness, there is yet another good reason to provide a favorable climate for industrial R&D. Several studies have estimated that the social rate of return to R&D spending exceeds the private rate of return, which itself is quite high. In other words, private companies tend to underinvest in R&D, mainly because they do not fully capture the benefits of their innovations. This is especially true for basic research that may have broad application outside its company of origin. Thus, it is plausibly argued that the government should stimulate private spending on

CHANGES IN COMPANY EXPENDITURES FOR INDUSTRIAL R & D
(constant dollars)



Note: Shaded areas show average growth rates for multiyear periods; the 1983 figure is estimated.
Source: National Science Foundation, Bureau of Economic Analysis.

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R&D in an attempt to bring it up to the "optimal" level.

The Tax Treatment of R&D—Then and Now

Before the Economic Recovery Tax Act, the tax treatment of R&D appeared to be more or less neutral. Immediate expensing was allowed for current R&D costs, as is done in other major nations; and plant and equipment used in R&D was both depreciable and eligible for the investment tax credit. Roughly offsetting these minor incentives was the bias in the tax code resulting from the difficulty that firms (especially new or rapidly expanding ones) have in taking full advantage of deductions and credits. Certainly there were no glaring tax shelters for R&D, like those sprinkled throughout the tax code for various other forms of investment.

The R&D tax credit, which went into effect July 1, 1981, allows firms to deduct from their tax liability an amount equal to 25 percent of their R&D spending in excess of a base-period amount. For 1983 and later years, the base is the average of eligible expenditures for the previous three years. (In 1981, only second-half spending was eligible, and the base was defined as half of R&D spending the previous year. In 1982, the base was the firm's spending during the two previous years.) Applying the credit only to increases in R&D over the base was meant to confer a significant stimulus without having to subsidize a firm's entire research budget. Activities eligible for the credit are R&D "in the experimental or laboratory sense" that is conducted "in carrying on" the firm's existing trade or business. Eligible expenditures include researcher's wages, research supplies, rent for equipment, and 65 percent of all contract research. Direct purchases of R&D plant and equipment do not qualify for the R&D credit, but are of course eligible for an investment tax credit (6 percent on equipment, 10 percent on structures) and for accelerated depreciation.

Other provisions in the 1981 act also helped R&D. The act increased the deduction for donations of new R&D equipment to universities, and it suspended for two years a requirement that increased the U.S. tax liability of firms doing business abroad by making them allocate some of their R&D costs against their foreign operations. Nevertheless, the tax credit was by far the most important of these provisions. A National Science Foundation study estimated that firms would earn $1 billion in R&D tax credits during 1983. Subsequently, the Office of Management and Budget has estimated that credits used during fiscal year 1983 resulted in a revenue loss of $600 million.

How a Firm Sees the Tax Credit

How the credit works in practice depends on how it appears from the viewpoint of the corporate manager. At first glance, a 25-percent tax credit would seem to be a powerful incentive. It looks like a bargain-basement sale—buy your usual supply of R&D at regular price and get all you want above and beyond that at one-fourth off. But wait!

First, to take advantage of the tax credit your firm must have tax liabilities, which means it must be profitable. Of course, you are allowed to carry the credit forward for fifteen years, but if you do, the credit (like any deferred payment) will be worth less. This presents no problem for established, prosperous firms, but new ventures or firms in declining industries may be cut off from the credit because they are still in the red. Since new firms can be fertile sources of innovation, and since productivity-enhancing innovation may be the key to rejuvenating our smokestack industries, an R&D stimulus that is of no immediate use to such firms is questionable.

Second, the incremental feature of the credit does some queer things to your incentives. Perhaps the most serious is that, if you increase your R&D spending this year, you have automatically increased your base for each of the next three years and that *raises* the amount by which you will have to increase your R&D in those years to be eligible for more tax credits. In other words, an increase in spending this year earns you a credit, but it also reduces the value of the credits you can hope to get in future years. For example, a $100 increase in R&D spending will earn a tax credit of $25. But this will raise the base R&D level for each of the next three years so that the R&D eligible for a credit will be reduced by $33 each year. The firm will therefore lose its chance for future credits totaling the same $25 (3 x 0.25 x $33). So the incentive for raising your R&D spending now, rather than later, equals not $25

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but just the interest value of getting the $25 now rather than later. Assuming an interest rate of 10 percent, the discounted value of speeding up a $100 boost in spending is only $4.29, far less than the apparent $25 value of the credit.

Next, in some not-too-unrealistic scenarios an increase in R&D could actually raise a firm's taxes. Suppose that this year's planned R&D spending is below your base—so no tax credits will be forthcoming—and that large R&D increases are planned for future years. By reducing this year's R&D budget, you would reduce future-year base amounts and thus raise its future tax credits. So the peculiar incremental feature of the credit could encourage your firm to *reduce* spending during the present year, or at least postpone that spending until it becomes eligible for a credit.

Nor is that all. Because of the way its incentives work, the tax credit will lose much of its kick during an economy-wide slowdown in R&D, as growing numbers of firms become ineligible for it. In fact, as already noted, your firm may even be pushed into further R&D reductions in order to increase future tax credits when the R&D outlook brightens. So the tax credit is procyclical, rather than countercyclical, meaning that it is more likely to accentuate R&D spending cycles than smooth them out. When corporate R&D is sprinting ahead, the incremental tax credit administers a shot of adrenaline; when R&D slumps, it offers a placebo instead, if not a sedative. Since *curing* slowdowns was part of the rationale for the tax credit, it is remarkable that the Congress wound up establishing a program that cuts in the opposite way.

So the tax credit is procyclical, rather than countercyclical, meaning that it is more likely to accentuate R&D spending cycles than smooth them out.

The interesting question, of course, is whether the tax stimulus concept makes sense. Is R&D susceptible to short-term changes in tax treatment? Clearly the proponents of the tax credit thought it was.

The philosophy behind the tax credit would appear to perceive R&D as a form of investment. R&D is, after all, spending in the present for a stock (of knowledge) from which future benefits will flow. If we can have an investment tax credit, why not use a similar approach for R&D? But a closer look at the nature of R&D shows it to be relatively unresponsive to changes in its tax treatment, particularly to incentives believed to be temporary.

In the first place, research requires a long-term commitment from the firm. Researchers and technicians must be assembled, equipment acquired (and maybe designed first) and put into place, and work of uncertain duration planned. A temporary (one- or two-year) increase in R&D funding is of much less value to such an undertaking than a permanent increase because the R&D must be sustained over a number of years before it will pay off.

Second, R&D is only part of the process that leads to innovation; the firm must incorporate the results of R&D into a full-scale plant, supported by capital investment, raw materials, labor, energy, marketing facilities, and consumer demand. Further, if all of this is ever to be profitable, the innovation must be applied on a larger scale via a process whereby other plants replicate the methods and products that have proved successful in the pioneer plant. All these steps are necessary; they are also expensive, perhaps more so than the original R&D. But they are not eligible for the credit. Thus, assuming that R&D accounts for only half of the cost of the total innovation package, a 25-percent discount on R&D would —in the eyes of the manager—really be only a 12.5-percent discount on innovation.

Judging from its behavior in the aggregate, R&D may be harder to budge than other types of spending. Between 1970 and 1982, for example, the annual variation of business fixed investment around its trend (measured in constant dollars) exceeded that of R&D by about 40 percent. This suggests that R&D may be less susceptible to changes in business conditions and to tax policy than is plant and equipment spending.

All of this serves as more evidence that the incremental tax credit in its current form probably has little effect on R&D *activity*. But reported R&D *spending* is a different matter. Now that the 25-percent tax credit is available, managers must be sorely tempted to classify as much spending as possible as "research and experimentation" for tax purposes, quite inde-

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pendently of whether it really fits that description. The Treasury Department, having had to deal with a number of outrageous R&D deductions, has urged Congress to tighten the definition of R&D. Meanwhile there has been a misleadingly large increase in the amount of R&D that companies have claimed. A Treasury Department sample of tax returns for 1981 showed a 43 percent surge in industrial R&D claimed for tax purposes, whereas *Business Week*'s survey of R&D spending for that year revealed only a 14.9 percent increase in spending (both measured in current dollars). This confusion has greatly hindered evaluations of whether the tax credit "worked," and hence we must rely on impressions such as the following.

Did the Tax Credit Achieve Its Purpose?

As the chart shows, a boom in R&D spending was well under way before the credit took hold in mid-1981, and continued into the sharp recession of 1981–82 with no clear departure from the post-1974 trend. In light of the above theoretical analysis of how a firm would view the credit, my guess is that the credit's impact on actual (as opposed to reported) R&D was positive but too small to be measured.

So what did cause R&D to revive in the late 1970s? No one has produced a good explanation of this, or of the earlier slowdown either. R&D spending changes with almost glacial slowness compared with such volatile indicators as interest rates, housing starts, and investment in plant and equipment. Thus, there is less change to explain, often not even enough to allow conclusive statistical results. Perhaps the best interpretation, though hardly a satisfying one, is that the slowdown was caused by increasing uncertainty over the long-term future of the economy, and that the resurgence was caused by industry's renewed appreciation of the benefits to be derived from innovation, brought about partly by the technological successes of our competitors.

The R&D tax credit expires December 31, 1985. It was billed as an experiment, on the theory that we would learn in four-and-a-half years whether it works well enough to be made permanent. Unfortunately, little of relevance has been learned. There has been no "experiment" in the usual sense of the word, of course, since we cannot know how big R&D spending would have been in the absence of the credit. The fact that firms have claimed large amounts of R&D tax credits, even if entirely legitimate, proves nothing, since we do not know whether it was the credits—or some other factor—that caused R&D spending to rise. About all that will be learned is the likely cost to the Treasury of this sort of tax credit, a useful bit of information but only one aspect of the cost-effectiveness question.

Policy Alternatives

Granting the importance of industrial R&D to the nation's competitiveness and long-term economic growth, what kind of policy is most appropriate? First, we must decide what it is we want to achieve. If our goal is to give industrial R&D a quick shot in the arm, clearly tax policy is not the right instrument. In the short term, R&D is quite insensitive to its tax treatment, mainly because it takes so long to get it under way or change it. If on the other hand the goal is to prevent another slump in R&D, tax policy might play a role. An incremental tax credit of the current variety, however, is particularly ineffective on this score, since the incentive disappears as soon as a firm's R&D stops growing.

In the short term, R&D is quite insensitive to its tax treatment, mainly because it takes so long to get it under way or change it.

This defect could be cured by making the credit a percentage of a firm's total R&D, just like the investment tax credit. But how large should the percentage be? Sticking with 25 percent is scarcely feasible in these days of gigantic budget deficits, for it would reduce tax revenues by more than $10 billion. Lowering the percentage so that the cost to the Treasury would be roughly the same as under the current credit would be budgetarily feasible, but the tax credit it would yield might be as low as 3 percent. At the margin, the discount on an extra dollar of R&D spending would be only 3¢ versus the much greater discount that a properly designed incremental credit would of-

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fer. The improvement in stability and permanence would thus be offset by the reduced incentive. The dilemma is real: there is no way to produce a strong steady stimulus on the cheap.

My recommendation is to retain the incremental feature of the current tax credit but to hold the base constant rather than vary it with the firm's spending on R&D. This would increase the high leverage effect, since this year's spending would not undercut next year's tax credit by raising the base. Specifically I recommend that each firm's base be defined as the product of its average sales for the past five years multiplied by the industry-wide R&D-to-sales ratio for the same period. That way, a firm's base would (except in the most concentrated industries) be largely unaffected by its own R&D spending, thereby avoiding some of the strange effects already noted.

Some would argue that, in addition, the industry-wide base could be adjusted, either by legislation or a preset formula, so that the incentive would rise to counteract an R&D slump. In my view, however, that degree of fine-tuning would not be advisable, because predictability is essential to tax policy—and because, in any event, the fine-tuners would almost surely get the timing wrong.

This modified tax credit would, if made permanent, be significantly better than the existing version. Still, it is only "second-best" policy, though second best to an ideal that is unlikely to be implemented. That ideal is to promote the long-term health of industrial R&D while not interfering unduly with the market mechanism. Industrial R&D—like business investment—flourishes in periods of stable policy and economic growth and languishes in troubled times, even if it gets favorable tax treatment. This observation does not yield particularly practical policy guidance, since stable policy is universally prescribed and all but impossible to achieve. It does, however, suggest that fine-tuning of R&D policy may be the wrong approach altogether.

The fact is that every scheme that I know of for stimulating R&D suffers from one or more unavoidable flaws, if only the difficulty of coming up with a workable definition of R&D. Moreover, the R&D tax credit, jerry-built though it may be, is one of more than 200 equally artificial and complicated "tax expenditures," each one meant to encourage some kind of desired behavior by taxpayers. Ironically, the more of these tax incentives there are, the less effective each of them becomes because the less tax liability there is left to manipulate. The corporate tax has declined in importance as tax breaks have proliferated. In 1960, 23 percent of federal budget receipts amounting to 4.2 percent of GNP were collected in the corporate income tax. In 1982 the figures were 8 percent and 1.6 percent, and by 1990 they will be still lower. Once firms have succeeded in eliminating their tax liability, the R&D tax credit is of no use in changing their behavior.

Maybe the best way to get more industrial innovation (which is why we want R&D in the first place) is to allow immediate depreciation of all investment. The more rapidly investment proceeds, the sooner the productivity-enhancing results of R&D are embodied in new capital equipment. Moreover, this change (along with other simplification measures) would eliminate the thorny problem of defining R&D in the tax code, to the delight of IRS officials.

But fundamental tax reform and simplification is years away, at best, whereas Congress has to decide very soon whether to extend the R&D tax credit. An improved version of what we now have is probably all we can hope for.

The Treasury Department's alternative is a three-year extension of the existing credit (plus a tighter definition of R&D) for the purpose of gathering more evidence on how well the credit works. But conclusive data are unlikely to emerge, partly because of the difficulty in measuring R&D activity but mainly because it is impossible, by definition, to test a permanent tax credit scheme with an impermanent one. If I am correct that a credit believed to be permanent is far more effective than one that is temporary, and that the existing credit is not cost-effective, then the practical choice is between a revised permanent credit or none at all.

So a long-term decision should be made now. Even though the current provision runs through 1985, R&D is planned so far in advance (five years or more) that firms need to know *now* what tax treatment will be on the books during the decade ahead. Otherwise our tax policies will merely reward those who employ alert tax accountants, not those who foster the industrial research and development that is so clearly needed. ■

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Readings
of particular interest

Oranges, Diamonds, and Movie Bookings

"The Economics of Block Booking" by Roy W. Kenney and Benjamin Klein, in *Journal of Law and Economics*, vol. 26, no. 3 (October 1983), pp. 497-540.

Block booking is the practice of renting one motion picture to an exhibitor on condition that it also rent other features from the same company. Movie makers in the United States began using this marketing technique at least as far back as 1916. In the 1948 *Paramount Pictures* case, the U.S. Supreme Court declared that the block booking system violated the antitrust laws. The *Paramount* case applied only to theater bookings, but the Court's 1962 decision in *Loew's* extended the ban to movie rentals for television broadcast. In this article Roy W. Kenney and Benjamin Klein offer a rationale for block booking based on efficiency concerns. Kenney and Klein are associated with California State University at Northridge and University of California at Los Angeles, respectively.

The prime legal objection to block booking has been that it allows distributors to "extend" monopoly pricing power from one copyrighted picture to another, specifically from a hit film to less popular offerings. In *Loew's* the Supreme Court said that "the antitrust laws do not permit a compounding of the statutorily conferred monopoly" on a copyrighted film.

Many economic critics, however, have been dissatisfied with this line of reasoning. George Stigler has asked why the distributor could not make just as much money from his copyright on the hit simply by renting it out at a high price. In order to "overprice" the undesirable films, he must implicitly "underprice" the desirable one.

Stigler and others have speculated that the real function of block booking and other types of product "bundling" is to make possible a form of price discrimination. For example, the makers of early computers often sold their machines with a "tie-in" of high-priced tabulating cards. Customers with intense demand used a lot of tabulating cards and thus, in effect, paid a higher price than customers with weak demand. This tie-in would have been unnecessary if the manufacturer had had some way to gauge the intensity of buyers' demand in advance; then it could simply have charged differential prices for the computer itself. On this theory, films vary in their appeal from one market to another, so that setting a single block price results in different implicit prices for individual films across markets.

Kenney and Klein argue that this price-discrimination thesis is at variance with the facts of block booking in the movie business. That thesis assumes that movie makers could not tell which customers are especially eager to rent which individual films. But, in fact, in most markets there are many theaters and television stations that can compete with each other for the rights to a new film. In fact, distributors can and do rely on competitive bidding among TV stations to determine prices in each local market. This bidding offers distributors a more precise and profitable way to vary film prices among markets than does block booking, which suggests to the authors that block booking must serve some other purpose.

To elucidate that purpose, the authors compare film rentals with other markets for items of varying quality. Oranges sold in markets are one example. Some oranges in a shipment are better than others, but it would be unduly expensive for a grocer to rate and price each one individually. Setting a uniform price, however, encourages shoppers to rummage through the bin in search of the best specimens. This search leads to at least two kinds of costs. First, the search may itself damage the product; by bruising oranges, for example. Second, consumers will invest time in searching, even though (as-

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suming that all the oranges are eventually sold) they will not on average get a better product. This lower level of consumer satisfaction will be reflected in a lower demand and price for oranges, which will harm the manufacturer.

Sellers can use a number of techniques to reduce oversearch by consumers, including "blind" packaging, which makes quality inspection more difficult, selling goods in lots, and installing dispensing mechanisms. Putting a coded "pull date" on a grocery package, rather than an "open date" that can be read by the consumer, may discourage inefficient search for the freshest items. Often various methods are used in combination. A seller of potatoes, for example, can prepackage and sell them in opaque bags.

Any of these techniques, the authors say, may turn out to be both profit-maximizing and socially efficient in particular situations. Nonetheless, they involve some hidden costs. Shoppers may refuse to accept the below-average offerings of a dispensing system, discarding the offending objects on a nearby store shelf and going back to the dispenser for another try. More fundamentally, blind packaging constitutes an implied deal in which the seller agrees to maintain an average level of product quality; reneging on this deal may be a tempting way for the seller to reap short-term profits (before customers are driven away) that would have been unavailable under an open-packaging system. The fear of such reneging will lower customers' willingness to pay for blind-packaged goods.

Sellers therefore have an incentive to rebuild this consumer confidence. One way of doing this is for sellers to invest more in brand-name maintenance—thus making it more costly for themselves to renege on their quality reputation. Another way is to compromise the blindness of the sale, either by allowing some form of "peeking" by the consumer, or by making it easier for the consumer to reject the lowest-quality lots.

The authors apply this analysis to the DeBeers group, the diamond cartel that has surprised many observers by the persistence of its grasp on the world diamond market. DeBeers's Central Selling Organization (CSO) in 1980 accounted for an estimated 80–85 percent of the world's sales of gem-quality uncut diamonds (with much of the rest reportedly consisting of stolen merchandise). However, DeBeers does not itself mine most of the diamonds it sells, instead buying them from independent mine owners under long-term (five to ten year) contracts with monthly production quotas. It might seem that the mine owners could easily chisel on the cartel by producing diamonds at full throttle and selling their output independently at the world price. That raises the question: why do they refrain from doing so?

The answer, say Kenney and Klein, may lie in the details of the DeBeers selling scheme. The quality of uncut diamonds varies greatly, and customers would have an incentive to invest enormous sums in the search process if they could choose individual diamonds. Instead, DeBeers preassigns a box of diamonds to each individual buyer, meeting the buyer's specifications for shape, weight, and so forth, and carrying a preset price. The buyer is free to reject the box, but that almost never happens "because buyers who reject the diamonds offered them are deleted from the list of invited customers." A buyer, however, is allowed to object that particular stones have been misclassified by weight or other factors.

This system provides some protection to both buyer and seller from the reneging that is possible under a blind-selling scheme—both the reneging that DeBeers would engage in by offering diamonds of grossly poor quality, and the reneging its customers would engage in if they rejected lots of below-average quality that were honestly drawn from an adequate average group. The authors speculate that economies of scale may make the expected costs of the two types of reneging (and the measures taken to prevent them) lower at DeBeers than at independent diamond outlets. If so, then DeBeers may have kept its dominant position in diamonds through the efficiency of its marketing system rather than through conventional "monopolistic" practices.

Much of the orange-diamond analysis can be applied to the movie industry. It is notoriously difficult to guess the likely popularity of a film before it is released, the authors point out; success is not related very predictably to production costs, for example. If films were priced in advance according to some average formula, exhibitors could simply wait a week or two to see which ones became hits and then rent (or extend their rental of) those films while

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rejecting the duds. This problem might not be serious if the studio could reprice each movie after its success had become evident, but that turns out to be difficult or impossible for various reasons. After block booking was banned, studios increased their reliance on contracts entitling them to a percentage of theaters' receipts —thus recovering after the fact the same revenues that block booking allowed them to recover before the fact.

Industrial Air Pollution: A Case of Stationary Progress?

Controlling Industrial Pollution: The Economics and Politics of Clean Air by Robert W. Crandall (Brookings Institution, 1983), 199 pp.

When Congress enacted the 1970 amendments to the Clean Air Act, it instructed the Environmental Protection Agency to impose strict controls on "stationary sources" of air pollution such as factories and power plants to go alongside the controls on "mobile sources" such as vehicles. In 1980, according to the Department of Commerce, total outlays on air pollution control amounted to $25 billion, of which more than $15 billion is attributable to stationary sources. It is often claimed that, whatever their cost, the EPA controls have at least succeeded in making the air much cleaner than it would otherwise be. According to Robert Crandall of the Brookings Institution, there "is some evidence that emissions from automobiles have been reduced by federal new-car standards"—although at an unnecessarily high cost —"but no conclusive studies demonstrate similar success for federal stationary-source policies."

Crandall says the major evidence for the success of the latter standards consists of data on the concentrations of pollutants detected at various monitoring sites around the country. These data show a substantial drop in sulfur dioxide and carbon monoxide levels since the early 1970s, along with no improvement in the level of airborne particles and a rise for nitrogen oxide. Unfortunately, Crandall says, the quality control of the monitoring is poor. There are fewer than 100 monitoring sites for sulfur dioxide and carbon monoxide, and "monitors are not located randomly across a control region." A large number of monitoring sites are located in older central cities, where industrial activity is on the wane. The decline reported in concentrations may be partly illusory if polluters are simply relocating their operations away from the monitors.

Fragmentary data from the 1960s, furthermore, suggest that air quality was improving faster before 1970 than it did afterward. Although this data is highly inconclusive, Crandall says it calls into question the efficacy of EPA's regulatory efforts. Besides, what improvement there was in the 1970s might have owed more to high energy prices and the deceleration of industrial growth than to EPA's efforts.

EPA's data on air quality also do not correspond well with two other sets of government statistics, Crandall says. One is EPA's estimates of total emissions by stationary-source polluters; the other is Census Bureau data on the amount of pollutants manufacturers removed in pollution-control processes. The discrepancies suggest problems with either EPA's assumptions about compliance with its emissions standards, or its procedures for monitoring air quality, or both.

Part of the agency's problem is that its regulations do not foster the most efficient means of pollution abatement. EPA sets best-technology standards for thousands of different industrial processes, with separate standards for new and old plants. The standards are set to a variety of stringencies, so that the cost of controlling a marginal unit of a given pollutant can vary widely from one industry to another, between new and old plants in an industry, and from one process to another within a given plant. "For instance, particulate control in the utility sector costs only $36 to $680 per additional ton removed while it can cost as much as $1,010 to $3,030 in a secondary aluminum plant or $30,880 in a coke oven." To the extent that particulates from these sources are comparably harmful and affect the same localities, it should be possible to achieve both lower overall control costs and lower emissions by tightening controls on utilities while loosening controls on industry.

Even more important, EPA—in accord with congressional instructions—typically

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holds new plants to much more stringent standards than existing plants. It also grants variances and compliance delays to some old plants but rarely to new ones. Crandall charges that this "new-source bias" discourages investment in new plant and equipment.

Why would Congress burden new sources with disproportionate control costs? Crandall argues that the lawmakers have used environmental policy in this and other ways to slow the migration of industry from the industrial areas of the North to the South and West. Vote breakdowns indicate that congressional support for activist environmental policy came predominantly from low-growth northern industrial states. The policy may have worked as intended: An analysis by the author shows that in six of eight major polluting industry groups, Sunbelt plants are spending a bigger share of their value-added on air pollution control than are Frostbelt plants. In the two industry groups with the highest control costs, metals and refining, the control costs of the Sunbelt plants were 50 percent higher.

Finally, differentially strict standards within a given plant can lead to inefficiency. According to estimates from the Battelle Institute, the steel industry could lower its costs of removing particulates by nearly 30 percent if EPA were to tighten standards for sintering (a heating process) and coal yards while weakening standards for blast furnaces, open hearths, and scarfing (metal joining).

A strategy intended to equalize the marginal costs of emission controls might have to be altered if the particles given off in some processes are more hazardous than those given off in others. It is also important to note, the author says, that the steel industry is not complying with the EPA standards in their full stringency. Total particulate controls for integrated steel mills would cost nearly $3 billion a year if Battelle's model-plant analysis is correct. "Actual air pollution control costs in the entire steel industry are probably less than $400 million per year. Hence the industry must be considerably out of compliance, or the projected costs are too high."

Since at least 1976 EPA has been trying to make its regulatory approach more efficient. The agency has promoted a system of tradable rights ("offsets") that would allow one polluter to pay another—presumably one with a lower cost of control—to reduce its emissions below its legally permitted maximum. But the agency has run into problems in determining the appropriate geographic bounds of trading areas and in enforcing the emissions ceiling assigned to each participant. Furthermore, statutory restrictions hold new sources of major pollutants to strict engineering standards, which prevents them from trading with existing sources.

Crandall considers emissions fees an even more promising way to control many types of pollution. This approach, however, would tend to redistribute wealth drastically, which makes it politically unpopular in many quarters. Crandall offers a "two-part" fee scheme that is designed to reduce that problem. It would combine standards and fees so as to keep EPA's total tax collections quite low while still imposing the "correct" marginal disincentive for pollution.

Of course, the author concludes, no incentives system can work very well if EPA lacks the capacity to monitor its enforcement. Hence the first order of business should be for Congress to spend substantially more on EPA's policing functions.

EPA as Gulliver

Regulation and the Courts: The Case of the Clean Air Act by R. Shep Melnick (Brookings Institution, 1983), 404 pp.

During the past twenty years federal judges, who had long deferred to the expertise of administrators, have increasingly intervened to oversee regulatory policy making. This judicial activism has been both praised and criticized as a matter of legal doctrine, but there have been few systematic analyses of whether it has in fact succeeded in improving agency policy making. In this book R. Shep Melnick examines how the federal courts have shaped Environmental Protection Agency regulation of air pollution under the Clean Air Act. He concludes that the courts have been ill-suited to their new role as regulatory reformers: in this field "the consequences of court action are neither random nor beneficial." Melnick is assistant professor of government at Harvard and was formerly a research associate at the Brookings Institution.

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Judicial control begins at the procedural level: court decisions have forced EPA to follow more elaborate rulemaking procedures than those specified in the Administrative Procedures Act, precisely in order to facilitate judicial review later on (as well as to encourage public participation). On the level of substantive policy, courts have forced EPA into a number of highly controversial regulatory programs. For instance, they have required the agency to set extremely stringent air-quality standards and regulate more pollutants than it had intended, develop a complex program to prevent "significant deterioration" in areas with clean air, and draw up highly unpopular plans to curtail driving and parking in big cities. At the same time, the courts have made it harder for EPA to enforce standards once it sets them, and have fashioned compliance schedules for individual polluters that extend well past the act's deadlines for achieving air-quality standards. Melnick concludes that by pushing legislators and administrators in these two contradictory directions, the courts have been "exacerbating the tendency of these institutions to promise far more than they can deliver."

Some of the problems lie in the institutional nature of the judiciary. The author says judges are often unfamiliar with the administrative process and intent on doing what seems fair in the particular case, which can leave them poorly informed about the wider issues at stake. They also tend to view crucial policy questions as mere technical details, Melnick asserts. For example, when courts told EPA to prevent significant deterioration in air quality and to limit the use of tall smokestacks, they gave no indication what "significant" meant or how to tell a tall smokestack from a normal one. Agency officials ran into serious problems when they tried to put judicial doctrine into regulatory practice.

The decentralized nature of the federal court system has led to some further anomalies. Many cases involving broad questions of national policy have been decided by the liberal D.C. Circuit Court of Appeals, while the enforcement process has been largely overseen by the various district courts around the country. The D.C. circuit has tended to look favorably on environmentalist challenges, while dismissing EPA's pleas that it lacked the resources to regulate; the district courts are less well disposed toward regulation. Both environmental groups and industry seek out those courts that share their views in the phenomenon of "forum-shopping." The two groups of jurists have proved unable to coordinate their hundreds of decisions with each other.

The author says court decisions have also altered the political balance between the branches. Specifically, they have made the agency more responsive to the chairmen and staffs of congressional subcommittees, and less responsive to the White House. The courts frequently look to the legislative history of the Clean Air Act in hopes of guessing congressional intent as to how it should be interpreted. But legislative history is typically written by subcommittee staffers who are eager partisans of regulatory activism, whereas the legislative coalition that originally passed a bill may have held a much broader spectrum of views.

The diversity of congressional opinion on the clean-air issue became more apparent when the time came for EPA to enforce the ambitious rules that it (and the courts) had adopted. Many members of Congress suddenly noticed that the rules would impose large and visible costs on a lot of voters and began accusing the agency of being "out of control," blindly absolutist, and so forth. These protests had their own effects on judicial behavior, leading courts to block rigorous enforcement of the rules, but not to call into question the regulatory standards themselves.

To a remarkable extent, Melnick says, large sectors of the current EPA are themselves the products of court action. Court decisions have created a variety of program advocates within the agency, have vastly increased the power of lawyers at the expense of air-pollution control professionals, have pushed enforcement officials into piecemeal negotiations that weaken their bargaining position, and have encouraged the political leadership of the agency to settle for symbolic victories against pollution at the standard-setting stage instead of success at the enforcement stage.

Although the regulatory process has turned out to be more complex and less amenable to judicial control than the legal literature has made it out to be, Melnick says, there are a number of specific things judges can do to improve their oversight of regulatory processes. Among them are narrowly interpreting an agen-

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cy's "nondiscretionary duties," phrasing court orders in specific language, and discouraging agencies from reaching private consent agreements with plaintiffs. Without some such reforms, he says, EPA—far from running "out of control"—will continue to be tied down by thousands of Lilliputian strings all but invisible to those who view the agency from afar.

Regulatory Management in California

"Regulatory Reform: Assessing the California Plan" by Marsha N. Cohen, in *Duke Law Journal*, no. 2 (1983), pp. 231-284.

Not long after California led the tax revolt, it took a pioneering role in regulatory reform. In 1979 the California legislature passed a law creating a new agency called the Office of Administrative Law (OAL) with the power to review and approve all future regulations issued by state agencies. In this article Marsha N. Cohen of Hastings College of the Law, University of California, assesses the first two years of reform.

The new agency's powers were quite broadly defined, Cohen notes. If it finds a regulation to be lacking in "necessity," "authority," or "clarity," among several other qualities, it can send it back to the agency for revision or burial. The law also gave OAL a chance to review the state's entire 28,000-page body of existing regulations, which made up a fourteen-and-a-half-foot shelf. Unlike the Office of Management and Budget at the federal level, OAL can review all regulations, not just "major" ones. Moreover, it has some autonomy from the rest of the executive branch, although its decisions can be appealed to the governor. Originally, OAL's actions were nearly free from judicial review; later the legislature provided that "interested parties" could take the agency to court. [For background, see "More Governmental Innovation from the Golden State," Perspectives, *Regulation*, January/February 1981.]

It might be natural, Cohen observes, to judge the success of the reform effort by the intentions of the legislature. But in this case, although the measure passed by a nearly unanimous vote, the motives of various legislative factions differed greatly. Some legislators believed that regulation was simply excessive and should be severely limited; others believed that the ill effects of regulation could be remedied by procedural improvements. Thus the law's provisions include some that encourage deregulation (for example, OAL has almost no authority to review repeals of existing regulations) and others that strive to reform the regulation-making process in neutral ways.

The procedural reforms include requirements that agencies conduct oral hearings on request, keep a rulemaking file, respond to public comments, and state their reasons for adopting rules. Commentators have generally praised these reforms for improving the quality of agency regulation-writing. Some of them, however, smack of absolutism. For example, anyone who wants to can demand that an agency hold an oral hearing before taking any rulemaking action, however trivial. Similarly, agencies must respond to every comment in the rulemaking file, however irrelevant. The increased formality of the new rulemaking process, the author says, may be frustrating the intent of stimulating citizen involvement in the rulemaking process, by conferring an advantage on those who can make sophisticated contributions to the rulemaking file. On the other hand, the author expects there will not be as many lawsuits challenging agency rules, since the most flagrant irregularities will not make it past the review stage.

Cohen is considerably more troubled by OAL's power to second-guess the "necessity" of regulations. (OAL must base this decision on whether there is substantial evidence of necessity in the rulemaking file.) Cohen contends that the "necessity" criterion (which is undefined) corresponds to a longstanding statutory requirement that new rules be "reasonably necessary," but the state's courts have not defined that standard either. Even if that ambiguity can be cleared up, the question remains: necessary for what?

The danger, Cohen says, is that OAL will simply replace agencies' substantive judgment with its own, centralizing all regulatory decisions in its own hands and eliminating the role of agency expertise. Some regulatory decisions, she says, rest on factual suppositions, others on judgments. A regulation setting the level of a licensing fee, for example, may be based on specific estimates of costs and expected revenues.

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OAL can readily assess the "necessity" of such a decision. But an education requirement for occupational licensure is a matter of judgment, since it is hard to show that a professional must take some particular number of hours of clinical training rather than a bit more or less. "Perspective, philosophy, and judgment—particularly expert judgment—will ultimately play a significant role in formulating such standards." While the law explicitly forbids OAL to substitute its judgment for that of an agency, such substitution is inevitable if OAL is to judge the "necessity" of these decisions. At the federal level, incidentally, some reformers have proposed a statute whereby the rulemaking file would have to provide substantial support for the factual underpinnings of rules, but not for the judgments embodied in them.

Cohen concludes that OAL can best serve as an umpire between the regulators and the regulated if it avoids lurching to either side of the ideological spectrum on regulatory reform. If legislators perceive OAL as leaning toward one extreme or the other, they will begin to exempt programs and agencies from its review; legislative support will remain intact, however, if the agency is seen as serving the general cause of regulatory reform rather than any one side's programmatic agenda.

"Politics without Politicians" in Utility Regulation

The Politics of Public Utility Regulation by William T. Gormley, Jr. (Pittsburgh: University of Pittsburgh Press, 1983), 271 pp.

The political pressures on state utility commissioners have gotten more complicated in recent years, according to William T. Gormley, Jr., associate professor of political science at the University of Wisconsin at Madison. Legislators and governors complain when utility rates go up, although they usually avoid involving themselves in the detailed proceedings by which the commissioners decide the rate requests. Commissioners also feel pressure from the professionals on their own staffs, especially now that staffs are larger and dominated more by economists and lawyers than by engineers and accountants.

The most striking development in utility politics, according to Gormley, is that outside pressure groups have become an institutionalized part of the regulatory process. Some of these groups lobby against new power plants on environmental grounds; others press for lower rates for consumers and special help for the poorest customers. Most such groups were originally set up on an ad hoc basis, but over time many of them have established themselves as successful and quasi-permanent actors on the regulatory stage. Some state governments, moreover, have established official consumer advocates within the state bureaucracy. In thirteen states this position is held by the attorney general, and in eighteen others by a special consumer counsel. (These "proxy advocates," incidentally, differ from ombudsmen, whose role is to help consumers deal with the bureaucracy rather than to alter its overall policy.)

Gormley sent questionnaires to utility commissioners around the nation and interviewed regulators, commission staffers, utility executives, and public and private intervenors in twelve states. His object was to determine the policy preferences of these groups and the degree of "concurrence" in their views. He found that citizens' groups seemed to be more successful at influencing the agenda of the commissions than at influencing final issue outcomes. "On procedural issues," he says, "commissioners concur about equally with utility executives and grassroots activists. On substantive issues, though, commissioners are much more likely to agree with utility executives than with grassroots advocates." For instance, the survey participants were asked whether they agreed that "investor-owned utilities are generally more efficient than publicly owned utilities." Most of the commissioners (79 percent) and even more of the commission staffers (92 percent) agreed with that statement, compared with 96 percent of the utility executives, 36 percent of the "proxy advocates," and only 15 percent of the grassroots advocates. Likewise, commission members and staffers favored the use of fuel adjustment clauses by margins of ten-to-one and eight-to-one respectively, while only 28 percent of the grassroots advocates took that position.

Among regulators, lawyers differed significantly from nonlawyers on many issues, with lawyers generally taking positions that are

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more hostile to utilities. However, lawyers are opposed to direct election of utility commissioners by an even greater margin than nonlawyers (90 percent to 75 percent).

Citizens' groups are now active participants in utility regulation in around half the states, the survey found. As might be expected, they are especially active in states where rates are high. Perhaps more surprising, they are more active in states where utility commissioners are appointed rather than elected, possibly because they "assume that elected agency officials can be trusted to safeguard their interests."

Some citizens' groups have won access to official sources of funding: 13 percent say they get money from the federal legal services program, 19 percent from other federal programs, and 25 percent from state government. But they are often ineffective in the goal that most of them share, blocking rate increases, the author says. The reason is that they lack the resources and expertise to address the sort of highly complex issues that figure in revenue requirements decisions.

The "official" consumer advocates within state governments have far bigger budgets and can thus address the complexities of revenue requirements issues, but the author found their issue priorities to be sharply different from those of the grass-roots advocates. They usually avoid issues that pit one group of consumers against another, such as "lifeline" rates, discounts for the elderly, and proposals to shift costs from residential to business customers. Gormley believes that the "proxy advocates" stay out of conflicts between groups of consumers for fear of splitting their political constituency—a strategy that keeps the agencies popular in state legislatures, but results in what the author calls a "lowest common denominator" approach to representation. States with official advocates were just as likely as other states to have a high level of grass-roots activism, which suggests to Gormley that the official advocates are not a very good substitute for the private variety. He believes states would do better to acknowledge the diversity of consumer interests and foster consumer advocacy through programs that reimburse private groups for the cost of testifying (intervenor funding).

Some critics have decried the "revolving door" by which employees shuttle from regulated industry to commission and back again. Gormley found, however, that regulators who have worked for a utility are no more likely than other regulators to take pro-industry policy stands. It is even possible, he says, that former utility employees may sometimes be tougher critics of utility arguments, because they "know where to find skeletons in the closet." This finding, he says, is consistent with other recent studies that have found the "revolving door effect" to be weak at best, at least on the "entry" side (although the possibility remains open that regulators might be swayed by hopes of working for a utility after they leave the government).

Gormley identifies a number of other factors that seem to make state commissions more acquiescent to utility interests, if not actually "captured" by them. One is the absence of active, effective public advocacy groups. Another is underfunding and understaffing, which can keep commissions from developing an independent information base. But although commissions that are rich in money and resources may avoid "capture," they do not necessarily share the views of consumer groups. Instead, Gormley finds, they have their own policy preferences, or in practice borrow them from one or another of the professions represented on commission staffs. Economists, for instance, are enamored of marginal cost pricing in rate structures, while lawyers favor more elaborate hearing procedures with fuller public participation.

At the moment, Gormley argues, state utility regulation is subject to political pressure, but not much of it comes from elected officials —resulting in a sort of "politics without politicians." He supports the initiative process, not because it will affect regulatory outcomes directly, but because its presence serves as a threat to spur politicians to tackle utility issues. He also suggests ending the civil service status of some commission staff positions so as to promote flexible (and politically aware) personnel policies. Paradoxically, he says, consumer groups may be mistaken in advocating direct election of commissioners as a pro-consumer measure: he argues that elected commissioners pursue voter support through "casework" and speech making, not by more pro-consumer policy making.

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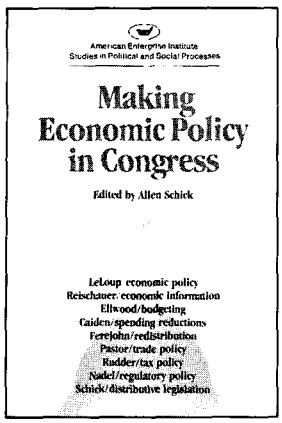

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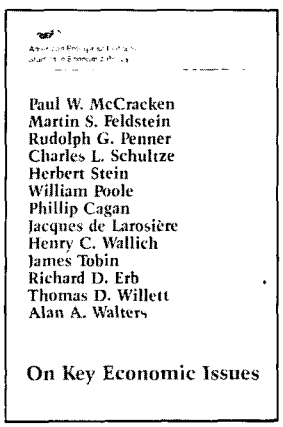

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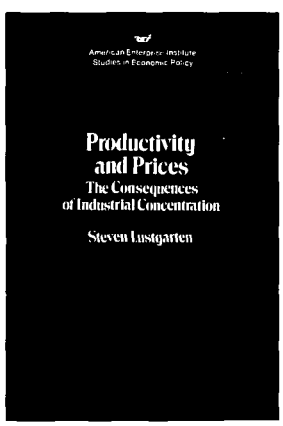

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